UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

May 25, 2010

IN THE MATTER OF ACT CLEAN TECHNOLOGIES, INC. File No. 500-1	ORDER OF SUSPENSION OF TRADING

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

1a of 47

SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for **July 2010,** with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act.

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

MARY L. SCHAPIRO, CHAIRMAN

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

(47 Documents)

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-3043; File No. S7-18-09

RIN 3235-AK39

Political Contributions by Certain Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting a new rule under the Investment Advisers Act of 1940 that prohibits an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. The new rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser, unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay to play restrictions. Additionally, the new rule prevents an adviser from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The Commission also is adopting rule amendments that require a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees. The new rule and rule amendments address "pay to play" practices by investment advisers.

DATES: Effective Date: [insert date 60 days after publication in Federal Register].

Compliance Dates: Investment advisers subject to rule 206(4)-5 must be in compliance with the rule on [insert date six months after the effective date]. Investment advisers may no longer use third parties to solicit government business except in compliance with the rule on [insert date one year after the effective date]. Advisers to registered investment companies that are covered investment pools must comply with the rule by [insert date one year after the effective date]. Advisers subject to rule 204-2 must comply with amended rule 204-2 on [insert date six months after the effective date]. However, if they advise registered investment companies that are covered investment pools, they have until [insert date one year after the effective date] to comply with the amended recordkeeping rule with respect to those registered investment companies. See section III of this Release for further discussion of compliance dates.

FOR FURTHER INFORMATION CONTACT: Melissa A. Roverts, Senior Counsel, Matthew N. Goldin, Branch Chief, Daniel S. Kahl, Branch Chief, or Sarah A. Bessin, Assistant Director, at (202) 551-6787 or IArules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is adopting rule 206(4)-5 [17 CFR 275.206(4)-5] and amendments to rules 204-2 [17 CFR 275.204-2] and 206(4)-3 [17 CFR 275.206(4)-3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] ("Advisers Act" or "Act").[1]

[1] 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified, and when we refer to rule 206(4)-5, rule 204-2, rule 204A-1, rule 206(4)-3, or any paragraph of these rules, we are referring to 17 CFR 275.206(4)-5, 17 CFR 275.204-2, 17 CFR 275.204A-1 and 17 CFR 275.206(4)-3, respectively, of the Code of Federal Regulations, in which these rules are published.

TABLE OF CONTENTS

I. BACKGROUND

Investment advisers provide a wide variety of advisory services to state and local governments,[2] including managing their public pension plans.[3] These pension plans have over $2.6 trillion of assets and represent one-third of all U.S. pension assets.[4] They are among the largest and most active institutional investors in the United States;[5] the management of these funds affects publicly held companies[6] and the securities markets.[7] But most significantly, their management affects taxpayers and the beneficiaries of these

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2 *See* SOFIA ANASTOPOULOS, AN INTRODUCTION TO INVESTMENT ADVISERS FOR STATE AND LOCAL GOVERNMENTS (2d ed. 2007); Werner Paul Zorn, *Public Employee Retirement Systems and Benefits*, LOCAL GOVERNMENT FINANCE, CONCEPTS AND PRACTICES 376 (John E. Peterson & Dennis R. Strachota eds., 1st ed. 1991) (discussing the services investment advisers provide for public funds).

3 To simplify the discussion, we use the term "public pension plan" interchangeably with "government client" and "government entity" in this Release. However, our rule applies broadly to investment advisory activities for government clients, such as those mentioned here in this Section of the Release, regardless of whether they are retirement funds. For a discussion of how the proposed rule would apply with respect to investment programs or plans sponsored or established by government entities, such as "qualified tuition plans" authorized by section 529 of the Internal Revenue Code [26 U.S.C. 529] and retirement plans authorized by section 403(b) or 457 of the Internal Revenue Code [26 U.S.C. 403(b) or 457], see section II.B.2(e) of this Release.

4 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS AND OUTSTANDINGS, FOURTH QUARTER 2009 78 tbl.L.119 (Mar. 11, 2010). Since 2002, total financial assets of public pension funds have grown by 28%. *Id.*

5 According to a recent survey, seven of the ten largest pension funds were sponsored by state and municipal governments. *The Top 200 Pension Funds/Sponsors*, PENS. & INV. (Sept. 30, 2008), *available at* http://www.pionline.com/article/20090126/CHART/901209995.

6 *See* Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008) ("Collectively, public pension funds have the potential to be a powerful shareholder force, and the example of CalPERS and its activities have spurred many to advocate greater institutional activism.").

7 Federal Reserve reports indicate that, of the $2.6 trillion in non-federal government plans, $1.5 trillion is invested in corporate equities. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 4, at 78 tbl.L.119.

funds, including the millions of present and future state and municipal retirees[8] who rely on the funds for their pensions and other benefits.[9] Public pension plan assets are held, administered and managed by government officials who often are responsible for selecting investment advisers to manage the funds they oversee.

Elected officials who allow political contributions to play a role in the management of these assets and who use these assets to reward contributors violate the public trust. Moreover, they undermine the fairness of the process by which public contracts are awarded. Similarly, investment advisers that seek to influence government officials' awards of advisory contracts by making or soliciting political contributions to those officials compromise their fiduciary duties to the pension plans they advise and defraud prospective clients. These practices, known as "pay to play," distort the process by which advisers are selected.[10] They can harm pension plans that may subsequently receive inferior advisory services and pay higher fees. Ultimately, these violations of trust can harm the millions of retirees that rely on the plan or the taxpayers of the state and municipal governments that must honor those obligations.[11]

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8 *See* PAUL ZORN, 1997 SURVEY OF STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT SYSTEMS 61 (1997) (hereinafter "1997 SURVEY") ("[t]he investment of plan assets is an issue of immense consequence to plan participants, taxpayers, and to the economy as a whole" as a low rate of return will require additional funding from the sponsoring government, which "can place an additional strain on the sponsoring government and may require tax increases").

9 The most current census data reports that public pension funds have 18.6 million beneficiaries. 2007 Census of Governments, U.S. Bureau of Census, Number and Membership of State and Local Government Employee-Retirement Systems by State: 2006-2007 (2007) (at Table 5), *available at* http://www.census.gov/govs/retire/2007ret05.html.

10 Among other things, pay to play practices may manipulate the market for advisory services by creating an uneven playing field among investment advisers. These practices also may hurt smaller advisers that cannot afford the required contributions.

11 *See* 1997 SURVEY, *supra* note 8.

Pay to play practices are rarely explicit: participants do not typically let it be publicly known that contributions or payments are made or accepted for the purpose of influencing the selection of an adviser. As one court noted, "[w]hile the risk of corruption is obvious and substantial, actors in this field are presumably shrewd enough to structure their relations rather indirectly."[12] Pay to play practices may take a variety of forms, including an adviser's direct contributions to government officials, an adviser's solicitation of third parties to make contributions or payments to government officials or political parties in the state or locality where the adviser seeks to provide services, or an adviser's payments to third parties to solicit (or as a condition of obtaining) government business. As a result, the full extent of pay to play practice remains hidden and is often hard to prove.

Public pension plans are particularly vulnerable to pay to play practices. Management decisions over these investment pools, some of which are quite large, are typically made by one or more trustees who are (or are appointed by) elected officials. And the elected officials or appointed trustees that govern the funds are also often involved, directly or indirectly, in selecting advisers to manage the public pension funds' assets. These officials may have the sole authority to select advisers,[13] may be members of a governing board that selects advisers,[14] or may appoint some or all of the board members who make the selection.[15]

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12 *Blount v. SEC*, 61 F.3d 938, 945 (D.C. Cir. 1995), *cert. denied*, 517 U.S. 1119 (1996).

13 *See, e.g.*, 2 N.Y. COMP. CODES R. & REGS. TIT. 2 § 320.2 (2009) (placement of state and local government retirement systems assets (valued at $109 billion as of March 2009) is under the sole custodianship of the New York State Comptroller).

14 *See, e.g.*, S.C. CODE ANN. §§ 9-1-20, 1-11-10 (2008) (board consists of all elected officials); CAL. GOV'T CODE § 20090 (Deering 2008) (board consists of some elected officials, some appointed members, and some representatives of interest groups chosen

Numerous developments in recent years have led us to conclude that the selection of advisers, whom we regulate under the Investment Advisers Act, has been influenced by political contributions and that, as a result, the quality of management service provided to public funds may be negatively affected. We have been particularly concerned that these contributions have been funneled through "solicitors" and "placement agents" that advisers engage (or believe they must engage) in order to secure a client relationship with a public pension plan or an investment from one.[16] As we will discuss in more detail below, in such an arrangement the contribution may be made in the form of a substantial fee for what may constitute no more than an introduction service by a "well connected" individual who may use the proceeds of the fee to make (or reimburse himself for having made) political contributions or provide some form of a "kickback" to an official or his or her family or friends.[17]

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by the members of those groups); MD. CODE ANN., STATE PERS. & PENS. § 21-104 (2008) (pension board consists of some elected officials, some appointed members, and some representatives of interest groups chosen by the members of those groups).

15 *See, e.g.*, ARIZ. REV. STAT. ANN. § 38-713 (2008) (governor appoints all nine members); HAWAII REV. STAT. § 88-24 (2008) (governor appoints three of eight members); IDAHO CODE ANN. § 59-1304 (2008) (governor appoints all five members).

16 For example, in one recent action we alleged that, in connection with a pay to play scheme in New York State, investment advisers paid sham "placement agent" fees, portions of which were funneled to public officials, as a means of obtaining public pension fund investments in the funds those advisers managed and that participants, in some instances, concealed the third-party solicitor's role in transactions from the investment management firms that paid fees to the solicitor by making misrepresentations about the solicitor's involvement and covertly using one of the solicitor's legal entities as an intermediary to funnel payments to the solicitor. *SEC v. Henry Morris, et al.*, Litigation Release No. 20963 (Mar. 19, 2009).

17 *See id.* (along with the Commission's complaint in the action, available by way of a hyperlink from the litigation release). *See also, e.g.*, *In the Matter of Quadrangle Group LLC*, AGNY Investigation No. 2010-044 (Apr. 15, 2010) (finding that "private equity firms and hedge funds frequently use placement agents, finders, lobbyists, and other intermediaries . . . to obtain investments from public pension funds . . . , that these placement agents are frequently politically connected individuals selling access to public money. . ."); Complaint, *Cal. v. Villalobos, et al.*, No. SC107850 (Cal. Super. Ct., W.

The details of pay to play arrangements have been widely reported as a consequence of the growing number of actions that we and state authorities have brought involving investment advisers seeking to manage the considerable assets of the New York State Common Retirement Fund.[18] In addition, we have brought enforcement actions against the former treasurer of the State of Connecticut and other parties in which we alleged that the former treasurer awarded state pension fund investments to private equity fund managers in exchange for payments, including political contributions, funneled through the former treasurer's friends and political associates.[19] Criminal

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Dist. of L.A. County, May 5, 2010), *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1915_filed_complaint_for_civil_penalties.pdf (alleging, *inter alia*, that a top executive and a board member at CalPERS accepted various gifts from a former CalPERS board member, "known among private equity firms as a person who attempts to exert pressure on CalPERS' representatives," who was acting as a placement agent trying to secure investments from the California public pension fund).

18 *See SEC v. Henry Morris, et al.*, Litigation Release No. 21036 (May 12, 2009); *In the Matter of Quadrangle Group LLC*, AGNY Investigation No. 2010-044 (Apr. 15, 2010); *In the Matter of GKM Newport Generation Capital Servs., LLC*, AGNY Investigation No. 2010-017 (Apr. 14, 2010); *In the Matter of Kevin McCabe*, AGNY Investigation No. 2009-152 (Apr. 14, 2010); *In the Matter of Darius Anderson Platinum Advisors LLC*, AGNY Investigation No. 2009-153 (Apr. 14, 2010); *In the Matter of Global Strategy Group*, AGNY Investigation No. 2009-161 (Apr. 14, 2010); *In the Matter of Freeman Spogli & Co.*, AGNY Investigation No. 2009-174 (Feb. 1, 2010); *In the Matter of Falconhead Capital, LLC*, AGNY Investigation No. 2009-125 (Sept. 17, 2009); *In the Matter of HM Capital Partners I, LP*, AGNY Investigation No. 2009-117 (Sept. 17, 2009); *In the Matter of Ares Management LLC*, AGNY Investigation No. 2009-173 (Feb. 17, 2010); *In the Matter of Levine Leichtman Capital Partners*, AGNY Investigation No. 2009-124 (Sept. 17, 2009); *In the Matter of Access Capital Partners*, AGNY Investigation No. 09-135 (Sept. 17, 2009); *In the Matter of The Markstone Group*, AGNY Investigation No. 10-012 (Feb. 28, 2010); *In the Matter of Wetherly Capital Group, LLC and DAV/Wetherly Financial, L.P.*, AGNY Investigation No. 2009-172 (Feb. 8, 2010) (in each case, banning the use of third-party placement agents pursuant to a "Pension Reform Code of Conduct").

19 *See SEC v. Paul J. Silvester, et al.*, Litigation Release No. 16759 (Oct. 10, 2000); Litigation Release No. 20027 (Mar. 2, 2007); Litigation Release No. 19583 (Mar. 1, 2006); Litigation Release No. 18461 (Nov. 17, 2003); Litigation Release No. 16834 (Dec. 19, 2000); *SEC v. William A. DiBella et al.*, Litigation Release No. 20498 (Mar. 14, 2008) (2007 U.S. Dist. LEXIS 73850 (D. Conn., May 8, 2007), *aff'd* 587 F.3d 553 (2nd Cir. 2009)). *See also U.S. v. Ben F. Andrews*, Litigation Release No. 19566 (Feb. 15,

authorities have in recent years brought cases in New York,[20] New Mexico,[21] Illinois,[22] Ohio,[23] Connecticut,[24] and Florida,[25] charging defendants with the same or similar conduct.

2006); *In the Matter of Thayer Capital Partners, TC Equity Partners IV, L.L.C., TC Management Partners IV, L.L.C., and Frederick V. Malek*, Investment Advisers Act Release No. 2276 (Aug. 12, 2004); *In the Matter of Frederick W. McCarthy*, Investment Advisers Act Release No. 2218 (Mar. 5, 2004); *In the Matter of Lisa A. Thiesfield*, Investment Advisers Act Release No. 2186 (Oct. 29, 2003).

20 *See New York v. Henry "Hank" Morris and David Loglisci*, Indictment No. 25/2009 (NY Mar. 19, 2009) (alleging that the deputy comptroller and a "placement agent" engaged in enterprise corruption and state securities fraud for selling access to management of public funds in return for kickbacks and other payments for personal and political gain).

21 *See U.S. v. Montoya*, Criminal No. 05-2050 JP (D.N.M. Nov. 8, 2005) (the former treasurer of New Mexico pleaded guilty); *U.S. v. Kent Nelson*, Criminal Information No. 05-2021 JP, (D.N.M. 2007) (defendant pleaded guilty to one count of mail fraud); *U.S. v. Vigil*, 523 F. 3d 1258 (10th Cir. 2008) (affirming the conviction for attempted extortion of the former treasurer of New Mexico for requiring that a friend be hired by an investment manager at a high salary in return for the former treasurer's willingness to accept a proposal from the manager for government business).

22 *See* Jeff Coen, et al., *State's Ultimate Insider Indicted*, CHI. TRIB., Oct. 31, 2008, *available at* http://www.chicagotribune.com/news/local/chi-cellini-31-oct31,0,6465036.story (describing the thirteenth indictment in an Illinois pay to play probe); Ellen Almer, Oct. 27, 2000, *available at* http://www.chicagobusiness.com/cgi-bin/news.pl?id=775 (discussing the guilty plea of Miriam Santos, the former treasurer of the City of Chicago, who told representatives of financial services firms seeking city business that they were required to raise specified campaign contributions for her and personally make up any shortfall in the amounts they raised). *See also SEC v. Miriam Santos, et al.*, Litigation Release No. 17839 (Nov. 14, 2002); Litigation Release No. 19269 (June 14, 2005) (355 F. Supp. 2d 917 (N.D. Ill. 2003)).

23 *See* Reginald Fields, *Four More Convicted in Pension Case: Ex-Board Members Took Gifts from Firm*, CLEVELAND PLAIN DEALER, Sept. 20, 2006 (addressing pay to play activities of members of the Ohio Teachers Retirement System).

24 *See U.S. v. Joseph P. Ganim*, 2007 U.S. App. LEXIS 29367 (2d Cir. 2007) (affirming the district court's decision to uphold an indictment of the former mayor of Bridgeport, Connecticut, in connection with his conviction for, among other things, requiring payment from an investment adviser in return for city business); *U.S. v. Triumph Capital Group, et al.*, No. 300CR217 JBA (D. Conn. 2000) (the former treasurer, along with certain others, pleaded guilty—while others were ultimately convicted). One of the defendants, who had been convicted at trial, recently won a new trial. *U.S. v. Triumph Capital Group, et al.*, 544 F.3d 149 (2d Cir. 2008).

25 *United States v. Poirier*, 321 F.3d 1024 (11th Cir.), *cert. denied sub nom. deVegter v. United States*, 540 U.S. 874 (2003) (partner at Lazard Freres & Co., a municipal services firm, was convicted for conspiracy and wire fraud for fraudulently paying $40,000

Allegations of pay to play activity involving state and municipal pension plans in other jurisdictions continue to be reported.[26] In the course of this rulemaking we received a letter from one public official detailing the role of pay to play arrangements in the selection of public pension fund managers and the harms it can inflict on the affected plans.[27] In addition, other public officials wrote to express support for a Commission rule to prohibit investment advisers from participating in pay to play arrangements.[28]

On August 3, 2009, we proposed a new antifraud rule under the Advisers Act designed to prevent investment advisers from obtaining business from government entities in return for political contributions or fund raising—*i.e.*, from participating in pay

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through an intermediary to Fulton County's independent financial adviser to secure an assurance that Lazard would be selected for the Fulton County underwriting contract).

26 *See, e.g.*, Aaron Lester, et al., *Cahill Taps Firms Tied to State Pension Investor*, BOSTON.COM, Mar. 21, 2010 (suggesting that an investment adviser may have bundled out-of-state donations to the Massachusetts State Treasurer's campaign in return for a state pension fund investment management contract); Kevin McCoy, *Do Campaign Contributions Help Win Pension Fund Deals*, USA TODAY, Aug. 28, 2009; Ted Sherman, *Pay to Play Alive and Well in New Jersey*, NJ.COM, Nov. 28, 2009 (noting more generally that pay to play continues to occur with government contracts of all kinds in New Jersey); Imogen Rose-Smith and Ed Leefeldt, *Pension Pay to Play Casts Shadow Nationwide*, INSTITUTIONAL INVESTOR, Oct. 1, 2009 (suggesting connections between a private equity fund principal's fundraising activities and pension investments in the fund). *See also* sources cited *supra* note 17.

27 Comment Letter of Suzanne R. Weber, Erie County Controller (Oct. 6, 2009) ("Weber Letter") ("I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen."). *See also* Comment Letter of David R. Pohndorf (Aug. 4, 2009) ("Pohndorf Letter") (noting that when the sole trustee of a major pension fund changed several years ago, a firm managing some of the fund's assets "began to receive invitations to fundraising events for the new trustee with suggested donation amounts.").

28 *See, e.g.*, Comment Letter of New York State Comptroller Thomas P. DiNapoli (Oct. 2, 2009) ("DiNapoli Letter"); Comment Letter of New York City Mayor Michael R. Bloomberg (Sept. 9, 2009) ("Bloomberg Letter"). *See also* Comment Letter of Kentucky Retirement Systems Trustee Chris Tobe (Sept. 18, 2009) ("Tobe Letter") (suggesting the negative effects of pay to play activities on the Kentucky Retirement System's investment performance).

to play practices.[29] We modeled our proposed rule on those adopted by the Municipal Securities Rulemaking Board, or MSRB, which since 1994 has prohibited municipal securities dealers from participating in pay to play practices.[30] We believe these rules have significantly curbed pay to play practices in the municipal securities market.[31]

Along the lines of MSRB rule G-37,[32] our proposed rule would have prohibited an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates.[33] It also would have prohibited an adviser and certain of its executives and employees from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business.[34] In

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29 *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 2910 (Aug. 3, 2009) [74 FR 39840 (Aug. 7, 2009)] (the "Proposing Release").

30 MSRB rule G-37 was approved by the Commission and adopted in 1994. *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule*, Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)]. The MSRB's pay to play rules include MSRB rules G-37 and G-38. They are available on the MSRB's Web site at http://www.msrb.org/msrb1/rules/ruleg37.htm and http://www.msrb.org/msrb1/rules/ruleg38.htm, respectively.

31 *See* Proposing Release, at n.23. *See also infra* note 101; Comment Letter of the Municipal Securities Rulemaking Board (Oct. 23, 2009) ("MSRB Letter"); Comment Letter of Common Cause (Oct. 6, 2009) ("Common Cause Letter").

32 *See* MSRB rule G-37(b). Our proposal, like MSRB rule G-37, was designed to address our concern that pay to play activities were "undermining the integrity" of the relevant market, in particular the market for the provision of investment advisory services to government entity clients. *See Blount*, 61 F.3d at 939 (referring to the MSRB's concerns that pay to play practices were "undermining the integrity of the $250 billion municipal securities market" as its motivation for proposing MSRB rule G-37).

33 Proposed rule 206(4)-5(a)(1). *See also* MSRB rule G-37(b).

34 Proposed rule 206(4)-5(a)(2)(ii). *See also* MSRB rule G-37(c).

addition, similar to MSRB rule G-38,[35] our proposed rule would have prohibited the use of third parties to solicit government business.[36] We also proposed amendments to rule 204-2 under the Advisers Act that would have required registered advisers to maintain certain records regarding political contributions and government clients. As discussed in more detail below, our proposed rule departed in some respects from the MSRB rules to reflect differences between advisers and broker-dealers and the scope of the statutory authority we have sought to exercise.

We received some 250 comment letters on our proposal, many of which were from advisers, third-party solicitors, placement agents, and their representatives.[37] Public pension plans and their officials were divided—some embraced the rule, including one that stated that the rule is an important means to "increase transparency and public confidence in the investment activities of all public pension funds,"[38] while others were critical, arguing, for example, that our proposal "may result in unintended hardships being placed upon public pension funds."[39] We received no letters from plan beneficiaries whom we sought to protect with the proposed rule,[40] although two public

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35 *See* MSRB rule G-38(a).

36 Proposed rule 206(4)-5(a)(2)(i).

37 Other commenters included pension plans and their officials, trade associations, law firms, and public interest groups. Comments letters submitted in File No. S7-25-06 are available on the Commission's web site at: http://www.sec.gov/comments/s7-18-09/s71809.shtml.

38 Comment Letter of New York City Comptroller William C. Thompson, Jr. (Oct. 6, 2009) ("Thompson Letter").

39 Comment Letter of Executive Director and Secretary to the Board of Trustees of the State Retirement and Pension System of Maryland R. Dean Kenderdine (Oct. 5, 2009).

40 We note, however, that subsequent to our proposal, AFSCME, which represents 1.6 million state and local employees and retirees, issued a report that strongly endorses sanctions to prevent pay to play activities. AFSCME, ENHANCING PUBLIC RETIREE PENSION PLAN SECURITY: BEST PRACTICE POLICIES FOR TRUSTEES AND PENSION

interest groups supported it strongly.[41] Advisers, third-party solicitors and placement agents, fund sponsors, and others whose business arrangements could be affected by the rule generally supported our goal of eliminating advisers' participation in pay to play practices involving public plans.[42] Nonetheless, most of them objected to our adoption under the Advisers Act of a rule similar to MSRB rules G-37 and G-38.[43] Most particularly opposed the proposed prohibition on payments to third parties for soliciting

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SYSTEMS (2010), *available at* http://www.afscme.org/docs/AFSCME-report-pension-best-practices.pdf.

41 *See, e.g.*, Common Cause Letter; Comment Letter of Fund Democracy/Consumer Federation of America (Oct. 6, 2009) ("Fund Democracy/Consumer Federation Letter").

42 *See, e.g.*, Comment Letter of the Investment Adviser Association (Oct. 5, 2009) ("IAA Letter") (noting "support [for] measures to combat pay to play activities, *i.e.*, the practice of investment advisers or their employees making political contributions intended to influence the selection or retention of advisers by government entities. Pay to play practices undermine the principle that advisers are selected on the basis of competence, qualifications, expertise, and experience. The practice is unethical and undermines the integrity of the public pension plan system and the process of selecting investment advisers."); Comment Letter of John R. Dempsey (Aug. 8, 2009) ("Dempsey Letter") (noting applause for efforts "to stop the 'pay-to-play' practice which only serves to undermine public trust in investment advisors and regulators."); Comment Letter of Barry M. Gleicher (Sept. 7, 2009) (noting strong support for the proposal "with no modifications. . . . The Rule is necessary to curb elaborated practices that would deprive taxpayers and beneficiaries of cost effective and honest administration of pension funds"); Tobe Letter.

43 *See, e.g.*, IAA Letter ("We respectfully submit, however, that the structure of the MSRB rules is not appropriately tailored to the investment advisory business. . . . We believe the Commission should make significant changes to the Proposal, which would permit it to accomplish its important goals."); Comment Letter of Wesley Ogburn (Aug. 4, 2009) ("Ogburn Letter"); Comment Letter of the Third Party Marketers Association (Aug. 27, 2009) ("3PM Letter"); Comment Letter of Preqin (Aug. 28, 2009) ("Preqin Letter I") (suggesting that institutional private equity investors polled favored a private equity specific proposal rather than relying on the framework from the municipal securities industry); Comment Letter of Dechert LLP (Oct. 22, 2009) ("Dechert Letter"); Comment Letter of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association (Oct. 13, 2009) ("ABA Letter"); Comment Letter of Fidelity Investments (Oct. 7, 2009) ("Fidelity Letter"); Comment Letter of Sutherland Asbill & Brennan LLP (Oct. 6, 2009) ("Sutherland Letter"); Comment Letter of the Investment Company Institute (Oct. 6, 2009) ("ICI Letter"); Comment Letter of the Massachusetts Mutual Life Insurance Company (Oct. 6, 2009) ("MassMutual Letter"); Comment Letter of Skadden, Arps, Slate, Meagher & Flom LLP (Oct. 6, 2009) ("Skadden Letter"); Comment Letter of the Managed Funds Association (Oct. 6, 2009) ("MFA Letter").

or marketing to government entities modeled on MSRB rule G-38.[44] Several urged that, if we were to adopt a rule based on the approach taken in our proposal, we should broaden exceptions and exemptions under the rule to accommodate certain business arrangements.[45] We respond to these comments below.[46]

II. DISCUSSION

As discussed in more detail below, we have decided to adopt rule 206(4)-5, which we have revised to reflect comments we received. For the reasons we discuss above and in the Proposing Release, we believe rule 206(4)-5 is a proper exercise of our rulemaking authority under the Advisers Act to prevent fraudulent and manipulative conduct.

The Commission regulates investment advisers under the Investment Advisers Act of 1940. Section 206(1) of the Advisers Act prohibits an investment adviser from employ[ing] any device, scheme or artifice to defraud any client or prospective client."[47]

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44 *See, e.g.*, Comment Letter of Ounavarra Capital, LLC (Aug. 28, 2009) ("Ounavarra Letter") (noting that banning third-party marketers in the municipal securities industry did not adversely affect most bankers' ability to conduct basic marketing whereas banning third-party marketers for small advisers could have a stronger impact on advisers that have either no or very limited marketing capability of their own); Comment Letter of MVision Private Equity Advisers USA LLC (Sept. 2, 2009) ("MVision Letter") (arguing that, whereas placement agents for municipal bond offerings are usually regulated entities, the restrictions in the municipal securities arena were targeted at consultants who offer only their contacts and influence with government officials and provided no valuable services to the financial services industry or investors); Comment Letter of Kalorama Capital (Sept. 8, 2009) (arguing that a better analogy, at least with respect to the operation of third-party marketers, is to the licensed professional presenting an IPO to a pension fund). For further discussion of these comments, see section II.B.2(b) of this Release.

45 *See, e.g.*, Comment Letter of the Committee on Investment Management Regulation and the Committee on Private Investment Funds of the Association of the Bar of the City of New York (Oct. 26, 2009) ("NY City Bar Letter") (arguing that broker-dealer rules have sufficient safeguards and that adopting the proposed pay to play rule will interfere with traditional distribution arrangements); Dechert Letter; Sutherland Letter; MFA Letter.

46 Particular comments on the various aspects of our proposal are summarized in the corresponding sub-sections of section II of this Release.

47 15 U.S.C. 80b-6(1).

Section 206(2) prohibits an investment adviser from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[48] The Supreme Court has construed section 206 as establishing a federal fiduciary standard governing the conduct of advisers.[49]

We believe that pay to play is inconsistent with the high standards of ethical conduct required of fiduciaries under the Advisers Act. We have authority under section 206(4) of the Act to adopt rules "reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative."[50] Congress gave us this authority to prohibit "specific evils" that the broad antifraud provisions may be incapable of covering.[51] The provision thus permits the Commission to adopt prophylactic rules that may prohibit acts that are not themselves fraudulent.[52]

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48 15 U.S.C. 80b-6(2).

49 *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

50 15 U.S.C. 80b-6(4).

51 S. REP. NO. 1760, 86th Cong., 2d Sess. 4, 8 (1960). The Commission has used this authority to adopt seven rules addressing abusive advertising practices, custodial arrangements, the use of solicitors, required disclosures regarding advisers' financial conditions and disciplinary histories, proxy voting, compliance procedures and practices, and deterring fraud with respect to pooled investment vehicles. 17 CFR 275.206(4)-1; 275.206(4)-2; 275.206(4)-3; 275.206(4)-4; 275.206(4)-6; 275.206(4)-7; and 275.206(4)-8.

52 Section 206(4) was added to the Advisers Act in Pub. L. No. 86-750, 74 Stat. 885, at sec. 9 (1960). *See* H.R. REP. NO. 2197, 86th Cong., 2d Sess., at 7-8 (1960) ("Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit . . . [Section 206(4)] would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of business which are fraudulent, deceptive, or manipulative. This is comparable to Section 15(c)(2) of the Securities Exchange Act [15 U.S.C. 78o(c)(2)] which applies to brokers and dealers."). *See also* S. REP. NO. 1760, 86th Cong., 2d Sess., at 8 (1960) ("This [section 206(4) language] is almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers."). The Supreme Court, in *United States v. O'Hagan*,

Investment advisers that seek to influence the award of advisory contracts by public pension plans, by making political contributions to, or soliciting them for, those officials who are in a position to influence the awards, compromise their fiduciary obligations to the public pension plans they advise and defraud prospective clients.[53] In making such contributions, the adviser hopes to benefit from officials who "award the contracts on the basis of benefit to their campaign chests rather than to the governmental entity"[54] or by retaining a contract that might otherwise not be renewed. If pay to play is a factor in the selection or retention process, the public pension plan can be harmed in

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interpreted nearly identical language in section 14(e) of the Securities Exchange Act [15 U.S.C. 78n(e)] as providing the Commission with authority to adopt rules that are "definitional and prophylactic" and that may prohibit acts that are "not themselves fraudulent ... if the prohibition is 'reasonably designed to prevent ... acts and practices [that] are fraudulent.'" *United States v. O'Hagan*, 521 U.S. 642, 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Securities Exchange Act. *See also Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] (stating, in connection with the suggestion by commenters that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under a particular rule, "We believe our authority is broader. We do not believe that the commenters' suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors.").

53 *See* Proposing Release, at section I; *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999) [64 FR 43556 (Aug. 10, 1999)] ("1999 Proposing Release"). As a fiduciary, an adviser has a duty to deal fairly with clients and prospective clients, and must make full disclosure of any material conflict or potential conflict. *See, e.g.*, *Capital Gains Research Bureau*, 375 U.S. at 189, 191-92; *Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)]. Most public pension plans establish procedures for hiring investment advisers, the purpose of which is to obtain the best possible management services. When an adviser makes political contributions for the purpose of influencing the selection of the adviser to advise a public pension plan, the adviser seeks to interfere with the merit-based selection process established by its prospective clients—the public pension plan. The contribution creates a conflict of interest between the adviser (whose interest is in being selected) and its prospective client (whose interest is in obtaining the best possible management services).

54 *See Blount*, 61 F.3d at 944-45.

several ways. The most qualified adviser may not be selected or retained, potentially leading to inferior management or performance. The pension plan may pay higher fees because advisers must recoup the contributions, or because contract negotiations may not occur on an arm's-length basis. The absence of arm's-length negotiations may enable advisers to obtain greater ancillary benefits, such as "soft dollars," from the advisory relationship, which might be used for the benefit of the adviser, potentially at the expense of the pension plan, thereby using the pension plan's assets for the adviser's own purposes.[55]

As we discuss above, pay to play practices are rarely explicit and often hard to prove.[56] In particular, when pay to play involves granting of government advisory business in exchange for political contributions, it may be difficult to prove that an adviser (or one of its executives or employees) made political contributions for the purpose of obtaining the government business, or that it engaged a solicitor for his or her political influence rather than substantive expertise.[57] Pay to play practices by advisers to public pension plans, which may generate significant contributions for elected officials and yield lucrative management contracts for advisers, will not stop through voluntary efforts. This is, in part, because these activities create a "collective action" problem in

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55 *Cf. In re Performance Analytics, et al.*, Investment Advisers Act Release No. 2036 (June 17, 2002) (settled enforcement action in which an investment consultant for a union pension fund entered into a $100,000 brokerage arrangement with a soft dollar component in which the investment consultant would continue to recommend the investment adviser to the pension fund as long as the investment adviser sent its trades to one particular broker-dealer).

56 *Cf. Blount*, 61 F.3d at 945 ("no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic").

57 *See id.* at 944 ("actors in this field are presumably shrewd enough to structure their relations rather indirectly").

two respects.[58] First, government officials who participate may have an incentive to continue to accept contributions to support their campaigns for fear of being disadvantaged relative to their opponents. Second, advisers may have an incentive to participate out of concern that they may be overlooked if they fail to make contributions.[59] Both the stealth in which these practices occur and the inability of markets to properly address them argue strongly for the need for us to adopt the type of prophylactic rule that section 206(4) of the Advisers Act authorizes.

A. First Amendment Considerations

The Commission believes that rule 206(4)-5 is a necessary and appropriate measure to prevent fraudulent acts and practices in the market for the provision of investment advisory services to government entities by prohibiting investment advisers from engaging in pay to play practices. We have examined a range of alternatives to our proposal, carefully considered some 250 comments we received on the proposal and made revisions to the proposed rule where we concluded it was appropriate. We believe the rule represents a balanced response to the developments we discuss above regarding pay to play activities occurring in the market for government investment advisory services. The rule provides specific prohibitions to help ensure that adviser selection is based on the merits, not on the amount of money given to a particular candidate for

58 Collective action problems exist, for example, where participants may prefer to abstain from an unsavory practice (such as pay to play), but nonetheless participate out of concern that, even if they abstain, their competitors will continue to engage in the practice profitably and without adverse consequences. As a result, collective action problems, such as those raised by pay to play practices, call for a regulatory response. For further discussion, *see infra* note 459 and accompanying text.

59 In our view, the collective action problem we are trying to address is analogous to the one noted in the case upholding MSRB rule G-37. *See Blount*, 61 F.3d at 945 ("Moreover, there appears to be a collective action problem tending to make the misallocation of resources persist"). For a discussion of concerns raised regarding our proposed rule that are similar to those raised regarding MSRB rule G-37, see section II.A of this Release.

office, while respecting the rights of industry participants to participate in the political process. The rule is not unique; Congress, for instance, has barred federal contractors from making contributions to public officials.[60]

Before we address particular aspects of the rule, we would like to respond to commenters' assertions that the fact that the rule's limitations on compensation are triggered by political contributions represents an infringement on the First Amendment guarantees of freedom of speech and association.[61] These commenters acknowledge that selection of an investment adviser by a government entity should not be a "pay back" for political contributions, but argue that the rule impermissibly restricts the ability of advisers and certain of their employees to demonstrate support for state and local officials.

The Commission is sensitive to, and has carefully considered, these constitutional concerns in adopting the rule. Though it is not a ban on political contributions or an attempt to regulate state and local elections, we acknowledge that the two-year time out provision may affect the propensity of investment advisers to make political contributions. Although political contributions involve both speech and associational rights protected by the First Amendment, a "limitation upon the amount that any one person or group may contribute to a candidate or political committee entails only a

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60 2 U.S.C. 441c.

61 *See, e.g.*, Comment Letter of W. Hardy Callcott (Aug. 3, 2009) ("Callcott Letter I"); Comment Letter of W. Hardy Callcott (Jan. 21, 2010) ("Callcott Letter II"); Comment Letter of the National Association of Securities Professionals, Inc. (Oct. 6, 2009) ("NASP Letter"); Comment Letter of Caplin & Drysdale, Chartered (Oct. 6, 2009) ("Caplin & Drysdale Letter"); Comment Letter of the Securities Industry and Financial Markets Association (Oct. 5, 2009) ("SIFMA Letter"); ABA Letter; Sutherland Letter; Comment Letter of IM Compliance LLC (Oct. 6, 2009) ("IM Compliance Letter"); Comment Letter of the American Bankers Association (Oct. 6, 2009) ("American Bankers Letter").

marginal restriction upon the contributor's ability to engage in free communication."[62] Limitations on contributions are permissible if justified by a sufficiently important government interest that is closely drawn to avoid unnecessary abridgment of protected rights.[63]

Prevention of fraud is a sufficiently important government interest.[64] We believe that payments to state officials as a *quid pro quo* for obtaining advisory business as well as other forms of "pay to play" violate the antifraud provisions of section 206 of the Advisers Act. As discussed in our Proposing Release, "pay to play" arrangements are inconsistent with an adviser's fiduciary obligations, distort the process by which investment advisers are selected, can harm advisers' public pension plan clients and the beneficiaries of those plans, and can have detrimental effects on the market for investment advisory services.[65] The restrictions inherent in rule 206(4)-5 are in the

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62 *Buckley v. Valeo*, 424 U.S. 1, 20 (1976). *See also SpeechNow.org, et al. v. FEC*, 599 F.3d 686 (D.C. Cir. 2010); *McConnell v. FEC*, 540 U.S. 93, 135-36 (2003).

63 *Buckley*, 424 U.S. at 25. *See also FEC v. Wisconsin Right to Life, Inc.*, 551 U.S. 449 (2007); *Republican Nat'l Comm. v. FEC,* No. 08-1953, 2010 U.S. Dist. LEXIS 29163 (D.D.C. Mar. 26, 2010) (three judge panel). This standard is lower than the strict scrutiny standard employed in reviewing such forms of expression as independent expenditures. Under the higher level of scrutiny, a restriction must be narrowly tailored to serve a compelling governmental interest. *Blount,* 61 F.3d at 943. *See also Citizens United v. FEC*, 130 S. Ct. 876 (2010) (distinguishing restrictions on "independent expenditures" from restrictions on "direct contributions" and leaving restrictions on direct contributions untouched while striking down a restriction on independent expenditures as unconstitutional). We note that in *Blount,* 61 F.3d at 949, the court upheld MSRB rule G-37 even assuming that strict scrutiny applied. For the reasons stated by the court in that decision, we believe that Rule 206(4)-5 would be upheld under a strict scrutiny standard as well as under the standard the Supreme Court has applied to contribution restrictions.

64 *Blount,* 61 F.3d at 944.

65 *See* Proposing Release, at section I. The prohibitions on solicitation and coordination of campaign contributions are justified by the same overriding purposes which support the two-year time out provisions. The provisions are intended to prevent circumvention of the time out provisions in cases where an investment adviser has or is seeking to establish a business relationship with a government entity. Absent these restrictions, solicitation and coordination of contributions could be used as effectively as political contributions to

nature of conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries.[66] Pursuant to our authority under section 206(4) of the Advisers Act, which we discuss above, we may adopt rules that are reasonably designed to prevent such acts, practices and courses of business.

As detailed in the following pages, we have closely drawn rule 206(4)-5 to accomplish its goal of preventing *quid pro quo* arrangements while avoiding unnecessary burdens on the protected speech and associational rights of investment advisers and their covered employees. The rule is therefore closely drawn in terms of the conduct it prohibits, the persons who are subject to its restrictions, and the circumstances in which it is triggered. The United States Court of Appeals for the District of Columbia Circuit upheld the similarly designed MSRB rule G-37 in *Blount v. SEC.*[67] Indeed, the *Blount* opinion has served as an important guidepost in helping us shape our rule.[68]

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distort the adviser selection process. The solicitation and coordination restrictions relate only to fundraising activities and would not prevent advisers and their covered employees from expressing support for candidates in other ways, such as volunteering their time.

[66] *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule,* Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)] (noting, in connection with the Commission's approval of MSRB rule G-37, that the restrictions inherent in that pay to play rule "are in the nature of conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries.").

[67] 61 F.3d at 947-48.

[68] Notwithstanding the *Blount* decision, some commenters asserted that subsequent Supreme Court jurisprudence, including *Randall v. Sorrell,* 548 U.S. 230 (2006), and *Citizens United*, 130 S. Ct. 876 (decided following the closing of the comment period for rule 206(4)-5), would result in the proposed rule being found unconstitutional because it is not narrowly tailored to advance the Commission's interests in addressing pay to play by investment advisers. *See, e.g.*, Callcott Letter I; Callcott Letter II; NASP Letter; American Bankers Letter. We disagree. The cases cited by commenters are distinguishable. *Citizens United* deals with certain independent expenditures (rather than contributions to candidates), which are not implicated by our rule. *Randall* involved a

First, the rule is limited to contributions to officials of government entities who can influence the hiring of an investment adviser in connection with money management mandates.[69] These restrictions are triggered only in situations where a business relationship exists or will be established in the near future between the investment adviser and a government entity.[70]

Second, the rule does not in any way impinge on a wide range of expressive conduct in connection with elections. For example, the rule imposes no restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches, and other conduct.[71]

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generally applicable state campaign finance law limiting overall contributions (and expenditures), which the Court feared would disrupt the electoral process by limiting a candidate's ability to amass sufficient resources and mount a successful campaign. *Randall*, 548 U.S. at 248-49. By contrast, our rule is not a general prohibition or limitation, but rather is a focused effort to combat *quid pro quo* payments by investment advisers seeking governmental business. Comparable restrictions targeted at a particular industry have been upheld under *Randall* because the loss of contributions from such a small segment of the electorate "would not significantly diminish the universe of funds available to a candidate to a non-viable level." *Green Party of Conn. v. Garfield*, 590 F. Supp. 2d 288, 316 (D. Conn. 2008). *See also Preston v. Leake*, 629 F. Supp. 2d 517, 524 (E.D.N.C. 2009) (differentiating the "broad sweep of the Vermont statute" that "restricted essentially any potential campaign contribution" from a statute that "only applies to lobbyists"); *In re Earle Asphalt Co.*, 950 A.2d 918, 927 (N.J. Super. Ct. App. Div. 2008), *aff'd* 957 A.2d 1173 (N.J. 2008) (holding that a limitation on campaign contributions by government contractors and their principals did not have the same capacity to prevent candidates from amassing the resources necessary for effective campaigning as the statute in *Randall*). One commenter expressly dismissed arguments that *Randall* would have implications for the Commission's proposed rule. Fund Democracy/Consumer Federation Letter.

69 *See* section II.B.2(a)(2) of this Release (discussing the definition of "official" of a government entity for purposes of rule 206(4)-5).

70 *See* section II.B.2(a)(1) of this Release (discussing the prohibition on compensation for providing advisory services to the client during rule 206(4)-5's two-year time out).

71 *See Citizens United*, 130 S. Ct. at 908-09 (noting that a government interest cannot be sufficiently compelling to limit independent expenditures by corporate entities). *See also SpeechNow.org*, 599 F.3d at 692 (spelling out the different standards of constitutional review established by the Supreme Court for restrictions on independent expenditures and direct contributions). Some commenters expressed concern, for example, that rule 206(4)-5 may quell volunteer activities, deter employees of investment

Third, it does not prevent anyone from making a contribution to any candidate, as covered employees may contribute $350 to candidates for whom they may vote, and $150 to other candidates. A limitation on the amount of a contribution involves little direct restraint on political communication, because a person may still engage in the symbolic expression of support evidenced by a contribution.[72] Furthermore, the rule takes the form of a restriction on providing compensated advisory business following the making of contributions rather than a prohibition on making contributions in excess of the relevant ceilings.[73]

Fourth, the rule only applies to investment advisers that are registered with us,[74] or unregistered in reliance on section 203(b)(3) of the Advisers Act, that have (or that are seeking) government clients.[75] It applies only to the subset of the significantly broader

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advisers from running for office, or chill charitable contributions. *See, e.g.*, Caplin & Drysdale Letter; NASP Letter. We have expressly clarified that volunteer activities and charitable contributions generally would not trigger the rule's time out provision and that employees running for office would not be subject to the contribution limitation. *See infra* notes 157 and 139, respectively.

72 *Buckley*, 424 U.S. at 21. *See also* section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to covered associates' contributions triggering the two-year time out). Some commenters raised constitutional concerns regarding the levels of the *de minimis* exception in our proposal. *See, e.g.*, Callcott Letter I; Callcott Letter II; Caplin & Drysdale Letter; IM Compliance Letter; Sutherland Letter. As discussed below, we have both raised the amount of the *de minimis* exception in line with inflation and added an additional exception.

73 *See* section II.B.2(a)(1) of this Release (discussing the two-year time out on receiving compensation for advisory services).

74 Unless indicated expressly otherwise, each time we refer to a "registered" investment adviser in this Release, we mean an adviser registered with the Commission.

75 *See* section II.B.1 of this Release (discussing advisers covered by the rule). One commenter raised constitutional concerns by arguing that the rule would apply beyond the advisory business of an adviser that solicits government clients, no matter how separate the other product or service offerings of the adviser are from the governmental business. ABA Letter. But we believe we have made clear that the rule's time out provisions, which are designed to eliminate *quid pro quo* arrangements and ameliorate market distortions, apply only with respect to the provision of advisory services to

set of advisers over which we have antifraud authority that we believe are most likely to be engaged by government clients to manage public assets either directly or though investment pools.[76]

Finally, the rule is not a restriction on contributions that is applicable to the public and is not intended to eliminate corruption in the electoral process. Rather, it is focused exclusively on conduct by professionals subject to fiduciary duties, seeking profitable business from governmental entities. The rule is targeted at those employees of an adviser whose contributions raise the greatest danger of *quid pro quo* exchanges,[77] and it covers only contributions to those governmental officials who would be the most likely targets of pay to play arrangements because of their authority to influence the award of advisory business.[78]

B. Rule 206(4)-5

We are today adopting new rule 206(4)-5 under the Advisers Act that is designed to protect public pension plans and other government investors from the consequences of pay to play practices by deterring advisers' participation in such practices.[79] As we noted

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government clients, which is consistent with our authority under the Advisers Act. *See* section II.B.2(a)(1) of this Release.

76 *See* section II.B.1 of this Release.

77 *See* section II.B.2(a)(4) of this Release (discussing the definition of "covered associates," whose contributions could trigger the two-year time out).

78 *See* section II.B.2(a)(2) of this Release (discussing the definition of "official" of a government entity for purposes of the rule 206(4)-(5)). Some commenters argued that the definition of "official" we included in our proposal was ambiguous. *See, e.g.*, Caplin & Drysdale Letter. In response, we have provided additional guidance. *See* section II.B.2(a)(2) of this Release.

79 Rule 206(4)-5 is targeted to a concrete business relationship between contributors and candidates' governmental entities. It is not intended to restrict the voices of persons and interest groups, reduce the overall scope of election campaigns, or equalize the relative ability of all votes to affect electoral outcomes. Indeed, if investment advisers do not seek government business from those to whom they and their covered associates make

in the Proposing Release, advisers and government officials might, in order to circumvent our rule, attempt to structure their transactions in a manner intended to hide the true purpose of a contribution or payment.[80] Therefore, our pay to play restrictions are intended to capture not only direct political contributions by advisers, but also other ways that advisers may engage in pay to play arrangements. Rule 206(4)-5 prohibits several principal avenues for pay to play activities.

First, the rule makes it unlawful for an adviser to receive compensation for providing advisory services to a government entity for a two-year period after the adviser or any of its covered associates makes a political contribution to a public official of a government entity or candidate for such office who is or will be in a position to influence the award of advisory business.[81] Importantly, as we noted in the Proposing Release, rule 206(4)-5 would not ban or limit the amount of political contributions an adviser or its covered associates could make; rather, it would impose a two-year time out on conducting compensated advisory business with a government client after a contribution

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contributions or for whom they solicit contributions, the rule's limitations will not be triggered. Rather, the rule is intended to prevent direct *quid pro quo* arrangements, fraudulent and manipulative acts and practices, and improve the mechanism of a free and open market for investment advisory services for government entity clients. With pay to play activities, the conflict of interest is apparent, the likelihood of stealth in the arrangements is great, and our regulatory purpose is prophylactic. *See Blount*, 61 F.3d at 945 (describing the court's similar characterization of MSRB rule G-37).

80 Proposing Release, at section II.A.

81 Rule 206(4)-5(a)(1) makes it unlawful for any investment adviser covered by the rule to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate, as defined in the rule, of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made). As noted below, an "official" includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has the authority to appoint any person who is directly or indirectly responsible for or can influence the outcome of the hiring of an investment adviser. *See* section II.B.2(a)(2) of this Release.

is made.[82] This first prohibition is substantially similar to our proposal. However, as discussed below, we have made certain modifications to some of the definitions of terms in this prohibition.[83]

Second, the rule generally prohibits advisers from paying third parties to solicit government entities for advisory business unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay to play restrictions.[84] That is, an adviser is prohibited from providing or agreeing to provide, directly or indirectly, payment to any person for solicitation of government advisory business on behalf of such adviser unless that person is registered with us and subject to pay to play restrictions either under our rule or the rules of a registered national securities association.[85] This represents a modification from our proposal, which included a flat ban without an exception for any brokers or investment advisers.[86] As discussed below,

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82 Proposing Release, at section II.A.

83 *See generally* section II.B.2(a) of this Release.

84 Rule 206(4)-5(a)(2)(i) makes it unlawful for any investment adviser covered by the rule and its covered associates (as defined in the rule) to provide or agree to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless such person is a regulated person or is an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the investment adviser. "Regulated person" is defined in rule 206(4)-5(f)(9). *See* section II.B.2(b) of this Release for a discussion of this definition.

85 *See* section II.B.2(b) of this Release. While our rule would apply to any registered national securities association, the Financial Industry Regulatory Authority, or FINRA, is currently the only registered national securities association under section 19(a) of the Exchange Act [15 U.S.C. 78s(b)]. As such, for convenience, we will refer directly to FINRA in this Release when describing the exception for certain broker-dealers from the rule's ban on advisers paying third parties to solicit government business on their behalf. The Commission's authority to consider rules proposed by a registered national securities association is governed by section 19(b) of the Exchange Act [15 U.S.C. 78s(b)] ("No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.").

86 *See* Proposing Release, at section II.A.3(b).

commenters persuaded us that the objective of the rule in eliminating pay to play activities of advisers could be preserved if the third parties they hire are themselves registered investment advisers subject to Commission oversight or are broker-dealers subject to pay to play restrictions imposed by a registered national securities association that the Commission must approve.

Third, the rule makes it unlawful for an adviser itself or any of its covered associates to solicit or to coordinate: (i) contributions to an official of a government entity to which the investment adviser is seeking to provide investment advisory services; or (ii) payments to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.[87] We are adopting this aspect of the rule as proposed.

Fourth, as it is not possible for us to anticipate all of the ways advisers and government officials may structure pay to play arrangements to attempt to evade the prohibitions of our rule, the rule includes a provision that makes it unlawful for an adviser or any of its covered associates to do anything indirectly which, if done directly, would result in a violation of the rule.[88] This provision in the rule we are adopting today is identical to our proposal.[89]

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87 Rule 206(4)-5(a)(2)(ii) makes it unlawful for any investment adviser covered by the rule and its covered associates to coordinate, or to solicit any person [including a political action committee] to make, any: (A) contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or (B) payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity. *See* section II.A.2.(c) of this Release.

88 Rule 206(4)-5(d) makes it unlawful for any investment adviser covered by the rule and its covered associates to do anything indirectly which, if done directly, would result in a violation of this section. *See* section II.B.2(d) of this Release.

89 *See* Proposing Release, at section II.A.3(d).

Finally, for purposes of our rule, an investment adviser to certain pooled investment vehicles in which a government entity invests or is solicited to invest will be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity.[90] This provision is substantially similar to our proposal, although we have made certain modifications described below.[91]

1. Advisers Subject to the Rule

Rule 206(4)-5 applies to registered investment advisers and certain advisers exempt from registration. In particular, it applies to any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)).[92] The rule would not, however, apply to most small advisers that are registered with state securities authorities instead of the Commission,[93] or advisers that are unregistered in reliance on exemptions other than section 203(b)(3) of the Advisers Act.[94]

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90 Rule 206(4)-5(c) states that, for purposes of rule 206(4)-5, an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest, shall be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity. See section II.B.2(e) of this Release.

91 *See* section II.B.2(e) of this Release.

92 Rule 206(4)-5(a)(1) and (2). Section 203(b)(3) [15 U.S.C. 80b-3(b)(3)] exempts from registration any investment adviser that is not holding itself out to the public as an investment adviser and had fewer than 15 clients during the last 12 months. We are including this category of exempt advisers within the scope of the rule in order to make the rule applicable to the many advisers to private investment companies that are not registered under the Advisers Act.

93 Advisers with less than $25 million of assets under management are prohibited from registering with the Commission by section 203A of the Advisers Act [15 U.S.C. 80b-3A].

94 The rule would also not apply to certain other advisers that are exempt from registration with the Commission. *See, e.g.*, section 203(b)(1) of the Advisers Act [15 U.S.C. 8b-3(b)(1)] (exempting from registration intrastate investment advisers). As explained in the Proposing Release, we believe these advisers are unlikely to advise public pension plans.

We received limited comment on this aspect of the rule. One commenter explicitly agreed with the scope of our proposed rule, noting that it would capture most, if not all, advisers that provide discretionary management with respect to public pension fund assets, regardless of whether they are registered.[95] Other commenters recommended that the rule apply more broadly to all advisers that may manage assets of government entities.[96] The primary effect of such an expansion of the rule would be to apply it to smaller firms, the regulatory responsibility for which Congress has previously allocated to the state securities authorities.[97] It is our understanding that few of these firms manage public pension plans or other public funds.[98] Accordingly, we have decided to adopt this provision as proposed.

See Proposing Release, at n.64 and accompanying text. The rule would also not apply to persons who are excepted from the definition of investment adviser under section 202(a)(11) of the Advisers Act [15 U.S.C. 80b-2(a)(11)]. For a discussion, in particular, of the exclusion of banks and bank holding companies which are not investment companies from the Advisers Act's definition of "investment adviser," see *infra* note 274.

95 Comment Letter of the California Public Employees' Retirement System (Oct. 6, 2009) ("CalPERS Letter") ("CalPERS agrees that the scope of the proposed rule would capture most if not all external managers who have discretion over the investment of public pension fund assets, including hedge fund managers, real estate managers, private equity managers, traditional long-only managers, money managers, and others, regardless of whether the managers are registered investment advisors. CalPERS supports application of the rule to investment advisers, as defined in the proposed rule.").

96 These suggestions included applying the rule to all registered (including SEC-registered and state-registered) and unregistered advisers (*see, e.g.*, 3PM Letter (arguing that selective application of the rule could lead to convoluted organizational structures designed to bypass its reach and that the proposal represents the kind of patchwork regulation that will lead to the kind of inconsistency the Commission is seeking to correct), and extending the rule to state-registered advisers (*see, e.g.*, Comment Letter of the Cornell Securities Law Clinic (Oct. 6, 2009) ("Cornell Law Letter")).

97 Amendments to the Advisers Act in 1996 placed the regulatory responsibility for these advisers in the hands of state regulators. *See* section 203A of the Advisers Act [15 U.S.C. 80b-3a] enacted as part of Title III of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

98 *See* Proposing Release, at n.64. We did not receive any comment challenging our understanding.

2. Pay to Play Restrictions

(a) Two-Year "Time Out" for Contributions

Rule 206(4)-5(a)(1) prohibits investment advisers from receiving compensation for providing advice to a "government entity" within two years after a "contribution" to an "official" of the government entity has been made by the investment adviser or by any of its "covered associates."[99] The rule does not ban political contributions and does not limit the amount of any political contribution. Instead, the rule imposes a ban—a "time out"—on receiving compensation for conducting advisory business with a government client for two years after certain contributions are made. The two-year time out is intended to discourage advisers from participating in pay to play practices by requiring a "cooling-off period" during which the effects of a political contribution on the selection process can be expected to dissipate.

Rule 206(4)-5(a)(1) is based largely on MSRB rule G-37 under which a broker-dealer is prohibited from engaging in the municipal securities business for two years after making a political contribution.[100] As noted above and as explained in the Proposing Release, we modeled the rule on the MSRB rules because we believe that they have significantly curbed pay to play practices in the municipal securities market.[101] We also

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99 Rule 206(4)-5(a)(1).

100 Proposing Release, at section II.A.2.

101 *See id.* at n.23 (citing others, including the MSRB, who agree that the MSRB rules have been effective: MSRB, *MSRB Notice 2009-62, Amendments Filed to Rule G-37 Regarding Contributions to Bond Ballot Campaigns* (Dec. 4, 2009), *available at* http://msrb.org/msrb1/archive/2009/2009-62.asp ("Rule G-37, in effect since 1994, has provided substantial benefits to the industry and the investing public by greatly reducing the direct connection between political contributions given to issuer officials and the awarding of municipal securities business to brokers, dealers and municipal securities dealers ("dealers"), thereby effectively assisting with eliminating pay-to-play practices in the new issue municipal securities market."); MSRB, *MSRB Notice 2009-35, Request for Comment: Rule G-37 on Political Contributions and Prohibitions on Municipal*

pointed out that our approach would minimize the compliance burdens on firms that would be subject to both rule regimes. But we requested comment on our proposed approach and whether alternative models might be appropriate.

Several commenters supporting the rule explicitly addressed the appropriateness of the MSRB approach. One, for example, asserted that the proposed rule "appropriately expands upon MSRB G-37 and G-38."[102] Another agreed that the MSRB rules "provide an appropriate regulatory analogy for addressing [pay to play] issues."[103] Many other commenters, however, sought to distinguish advisers and municipal securities dealers, and asserted that, because of the differences between the two, MSRB rule G-37 is an

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Securities Business – Bond Ballot Campaign Committee Contributions (June 22, 2009) ("The MSRB believes the rule has provided substantial benefits to the industry and the investing public by greatly reducing the direct connection between political contributions given to issuer officials and the awarding of municipal securities business to dealers, thereby effectively eliminating pay-to-play practices in the new issue municipal securities market." [footnote omitted]); MSRB, *MSRB Notice 2003-32, Notice Concerning Indirect Rule Violations: Rules G-37 and G-38* (Aug. 6, 2003) ("The impact of Rules G-37 and G-38 has been very positive. The rules have altered the political contribution practices of municipal securities dealers and opened discussion about the political contribution practices of the entire municipal industry."); Letter from Darrick L. Hills and Linda L. Rittenhouse of the CFA Institute to Jill C. Finder, Asst. Gen. Counsel of the MSRB (Oct. 19, 2001), *available at* http://www.cfainstitute.org/Comment%20Letters/20011019.pdf (stating, "We generally believe that the existing [MSRB] pay-to-play prohibitions have been effective in stemming practices that compromise the integrity of the [municipal securities] market by using political contributions to curry favor with politicians in positions of influence."); COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (stating, upon describing MSRB Rule G-37 and the 2005 amendments to MSRB Rule G-38, "Taken together, the MSRB's rules have largely put an end to the old "pay to play" practices in municipal underwriting.")). *See also* Comment letter of Professors Alexander W. Butler, Larry Fauver and Sandra Mortal (Sept. 30, 2009) ("Butler Letter") (citing Alexander W. Butler, Larry Fauver & Sandra Mortal, *Corruption, Political Integrity, and Municipal Finance*, 22 R. OF FIN. STUD. 2673-705 (2009)).

102 Common Cause Letter.

103 Comment Letter of Credit Suisse Securities (USA) LLC (Sept. 14, 2009) ("Credit Suisse Letter").

inappropriate model on which to base an investment adviser pay to play rule.[104] Some argued that the long-term nature of advisory relationships is fundamentally different from discrete municipal underwriting transactions, and consequently, the two-year time out is more disruptive and severe for advisers and the governments that retain them than for municipal securities dealers who are simply banned from obtaining "new" business as opposed to terminating a long-term relationship.[105] Some commenters asserted that the relationships are different because advisers provide ongoing and continuous advice as a fiduciary, rather than a one-time transaction such as an underwriting, and that advisory services are typically subject to an open competitive bid process instead of through negotiated transactions that are typical of municipal underwritings.[106]

We disagree that the differences between municipal securities underwriting and money management are sufficient to warrant an alternative approach. Commenters are correct that municipal securities underwriters provide episodic services rather than ongoing services often provided by money managers. But underwriters seek to provide

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104 *See, e.g.*, IAA Letter; ICI Letter; SIFMA Letter; ABA Letter; Dechert Letter; Skadden Letter; Comment Letter of Jones Day (Oct. 5, 2009) ("Jones Day Letter"); Comment Letter of Simpson Thacher & Bartlett LLP on behalf of Park Hill Group LLC and its affiliates (Sept. 21, 2009) ("Park Hill Letter"); Comment Letter of Monument Group, Inc. (Sept. 18, 2009) ("Monument Group Letter"). One commenter suggested, in particular, that the rule's two-year time out provision is outside of our authority because it imposes an "automatic penalty, subject only to discretionary post facto review." Comment Letter of Edwin C. Laurenson (Dec. 31, 2009). We disagree. The two-year time out is not a penalty. Rather, it is a "cooling-off period" to dissipate any effects of a *quid pro quo*. A violation of the provision would result from receiving, or continuing to receive, payment after making the contribution, not from the making of the contribution itself.

105 *See, e.g.*, IAA Letter; ABA Letter; Dechert Letter; Skadden Letter; Jones Day Letter; Park Hill Letter; Monument Group Letter. *But see* Credit Suisse Letter ("G-37 and G-38 provide an appropriate regulatory analogy"); Butler Letter ("This practice [municipal underwriting pay to play] was analogous to the type of pay to play currently under consideration by the Commission").

106 *See, e.g.*, IAA Letter; ICI Letter; SIFMA Letter; ABA Letter; Dechert Letter; Skadden Letter; Jones Day Letter; Park Hill Letter; Monument Group Letter.

repeated, if not ongoing, services, and the imposition of a two-year time out can have considerable competitive consequences to a broker-dealer whose government client must employ the services of a competitor whose services it may continue to employ after MSRB rule G-37's two-year time out has run its course. That advisers are in a fiduciary relationship with their public pension plan clients argues for at least as significant consequences for participation in pay to play practices that can harm these clients.

Our decision to adopt a rule based on the MSRB model is influenced primarily by our judgment that the MSRB rules have significantly curbed pay to play practices in the municipal securities market[107] and that alternative approaches, including those suggested by commenters, would fail to provide an adequate deterrent to pay to play activities. We considered each of the principal suggestions offered by commenters.

Some commenters suggested requiring advisers to disclose their contributions to state and local officials.[108] Statutes requiring disclosure of political contributions are, in part, designed to inform voters about a candidate's financial supporters; an informed electorate can then use the information to vote for or against a candidate.[109] But voters' possible reactions, if any, to such disclosure would not necessarily resolve the concerns we are trying to address in this rulemaking. Our concern is protecting advisory clients and investors whom we have the responsibility to protect under the Advisers Act—

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107 *See supra* notes 31 and 101 and accompanying text.

108 *See, e.g.*, SIFMA Letter; Preqin Letter I; Comment Letter of Triton Pacific Capital, LLC (Sept. 1, 2009) ("Triton Pacific Letter"); Comment Letter of the State Association of County Retirement Systems (Sept. 8, 2009); Comment Letter of CapLink Partners (Sept. 9, 2009) ("CapLink Letter"); Comment Letter of Parenteau Associates, LLC (Aug. 7, 2009) ("Parenteau Letter").

109 *See Buckley*, 424 U.S. at 67 (1976) (noting that campaign financing disclosure requirements "deter actual corruption and avoid the appearance of corruption by exposing large contributions and expenditures to the light of publicity").

namely, the public pension plans and their beneficiaries who are affected by pay to play practices.[110] Disclosure to a plan's trustees might be insufficient where the trustee (particularly a sole trustee) has received the contributions and is presumably well aware of the conflicts involved. Moreover, and as we pointed out in the Proposing Release, requiring advisers to disclose political contributions to beneficiaries would be unlikely to protect them since most cannot act on the information by moving their pension assets to a different plan or by reversing the plan trustees' adviser hiring decisions.[111] Not all beneficiaries may be entitled to vote (or withhold their vote) for the official to whom a contribution was made, and those that are may need to wait a substantial period of time until a future election to exercise their vote. Further, as beneficiaries may constitute only a small proportion of the electorate, they may not be able to influence an election; therefore, reliance on the electoral process may be insufficient to protect government plans and their beneficiaries from pay to play. In addition, even if the fact of a contribution is disclosed (which is required in many states), the contribution's true purpose is unlikely to be disclosed.

Several commenters suggested that the Commission adopt a requirement that an adviser include in its code of ethics[112] a policy that prohibits contributions made for the

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110 As discussed above, our purposes in this rulemaking are preventing fraud, protecting investors and maintaining the integrity of the adviser selection process, not campaign finance reform. *See* section I of this Release.

111 *See* Proposing Release, at section II.A.2. Some commenters made the same points. *See, e.g.*, NY City Bar Letter; Cornell Law Letter; 3PM Letter. *See also Blount*, 61 F.3d at 947 (explaining, in the context of the municipal securities industry, the potential inadequacy of disclosure to address pay to play concerns, that "disclosure would not likely cause market forces to erode 'pay to play . . .'" because the ". . . purpose of protecting the integrity of the market [would] . . . 'be achieved less effectively.'").

112 Registered investment advisers are required to have codes of ethics under the Advisers Act. *See* Advisers Act rule 204A-1.

purpose of influencing the selection of the adviser.[113] Several commenters recommended, similarly, that we require advisers to adopt policies and procedures[114] reasonably designed to prevent and detect contributions designed to influence the selection of an adviser.[115] Many of these commenters suggested that preclearance of employee contributions could be required under an adviser's code of ethics or compliance policies and procedures.[116] One commenter asserted that an advantage of this approach is that it would allow an adviser to customize sanctions based on the severity of the violation.[117]

We do not, however, believe that codes of ethics or compliance procedures alone would be adequate to stop pay to play practices, particularly when the adviser or senior officers of the adviser are involved either directly or indirectly. First, it is those senior officers who, as noted below, have the greatest incentives to engage in pay to play and therefore are most likely to make contributions, who would themselves ultimately be responsible for enforcing *their own* compliance with the firm's ethics code or compliance procedures. Second, violations of codes of ethics or compliance procedures do not themselves establish violations of the federal securities laws. Moreover, the comments suggesting these alternatives would have us require the codes or procedures be designed to prevent or detect contributions *intended to influence* the selection of the adviser by a

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113 *See, e.g.*, IAA Letter; ABA Letter; Comment letter of the National Society of Compliance Professionals, Inc. (Oct. 6, 2009) ("NSCP Letter"); NY City Bar Letter; Fidelity Letter.

114 Registered investment advisers are required to adopt and implement policies and procedures reasonably designed to prevent violation by the adviser or its supervised persons of the Advisers Act and the rules the Commission has adopted thereunder. *See* Advisers Act rule 206(4)-7.

115 *See, e.g.*, ABA Letter; NY City Bar Letter; IAA Letter; ICI Letter; NSCP Letter.

116 *See, e.g.*, IAA Letter; NY City Bar Letter; ABA Letter.

117 ABA Letter.

government entity. As discussed extensively above and in our Proposing Release, pay to play is an area in which intent is often very difficult to prove, and is often hidden in the guise of legitimate conduct.[118] Political contributions are made ostensibly to support a candidate; the burden on a regulator or prosecutor of proving a different intent presents substantial challenges absent unusual evidence. Commenters would thus have us give the adviser, which stands to benefit from the contribution, the discretion to determine whether contributions were intended to influence its selection by the government entity. We do not believe codes of ethics or policies and procedures alone, without a rule providing for specific, prophylactic prohibitions, are adequate to address this type of conduct.[119]

On balance, we believe that adopting a two-year time out for investment advisers similar to the two-year time out applicable to broker-dealers underwriting municipal securities is appropriate. Our years of experience with MSRB rule G-37 suggests that the "strong medicine" provided by that rule has both significantly curbed participation in pay to play and provides a reasonable cooling-off period to mitigate the effect of a political contribution. We are sensitive about potential implications of the operation of the rule on public pension funds, which could lose the services of an investment adviser subject to a time out. While we have designed the rule to reduce its impact,[120] investment advisers are best positioned to protect these clients by developing and enforcing robust

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118 *See, e.g.*, Proposing Release, at n.16 and accompanying text.

119 We note that, under our rules, an adviser's code of ethics must require compliance with the rule we are today adopting (rule 204A-1(a)(2)) and the adviser must adopt policies and procedures designed to prevent violation of the rule (rule 206(4)-7(a)).

120 *See, e.g.*, section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to the two-year time out); section II.B.2(f) of this Release (discussing the rule's exemptive provision).

compliance programs designed to prevent contributions from triggering the two-year time out.

(1) Prohibition on Compensation

As noted above, investment advisers subject to new rule 206(4)-5 are not prohibited from providing advisory services to a government client, even after triggering the two-year time out. Instead, an adviser is prohibited from receiving *compensation* for providing advisory services to the government client during the time out.[121] We have taken this approach to enable an adviser to act consistently with its fiduciary obligations so it will not have to abandon a government client after making a triggering contribution, but rather may provide uncompensated advisory services for a reasonable period of time to allow the government client to replace the adviser.[122] We are adopting this element of the rule as proposed.

One commenter supported the prohibition on compensation as the least disruptive option to government clients,[123] while others argued that the prohibition on compensation

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121 Rule 206(4)-5(a)(1) makes it unlawful for investment advisers covered by the rule to provide investment advisory services *for compensation* to a government entity within two years after a triggering contribution. Under the rule, the two-year time out begins to run once the contribution is made and not when the contribution is discovered either by our examination staff or by the adviser. The adviser, therefore, should return all such compensation promptly upon discovering the triggering contribution. For the application of the rule to investments by government entities in pooled investment vehicles, see section II.B.2(e) of this Release.

122 Proposing Release, at section II.A.3(a)(1). An investment adviser's fiduciary duties may require it to continue providing advisory services for a reasonable period of time under these circumstances. For another instance in which an adviser's fiduciary duties may require its continued provision of services, see *Temporary Exemption for Certain Investment Advisers*, Investment Advisers Act Release No. 1736 (July 22, 1998) [63 FR 40231, 40232 (July 28, 1998)] (describing an investment adviser's fiduciary duties to an investment company in the case of an assignment of the advisory contract).

123 Cornell Law Letter.

was unreasonable and, in some cases, difficult or near impossible to implement.[124] A coalition of commenters representing state and local governments asserted that, due to restrictions on accepting uncompensated services under state and local law, it was unlikely that government entities would accept uncompensated services even if an adviser were willing or required to provide them.[125] Commenters representing advisers took the opposite view, expressing concern that they would be locked into providing uncompensated services for extended periods of time as a result, and wanted the Commission to provide guidelines as to what a reasonable amount of time is for a government client to claim or move its assets.[126] One asserted that it would be unreasonable to require advisers to provide uncompensated services altogether.[127]

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124 *See, e.g.*, ICI Letter; Jones Day Letter. Some commenters argued for more flexibility in sanctions (Skadden Letter; ABA Letter; Fidelity Letter; ICI Letter; MassMutual Letter; Comment Letter of Wells Fargo Advisors (Oct. 6, 2009) ("Wells Fargo Letter"); IAA Letter).

125 Comment Letter of the National Conference of State Legislatures, National Association of Counties, National League of Cities, International City/County Management Association, National Association of State Auditors, Comptrollers and Treasurers, Government Finance Officers Association, National Association of State Retirement Administrators, National Conference on Public Employee Retirement Systems, and National Council on Teacher Retirement (Oct. 6, 2009) ("National Organizations Letter"). With respect to direct advisory relationships, because restrictions on governments receiving services without payment would be a function of particular state or local laws, we believe government entities and their advisers are in the best position to work out arrangements that are consistent with both state and local law and the compensation prohibition of our rule. With respect to investments by government entities in pooled investment vehicles, in particular, such restrictions could be avoided. *See* section II.B.2(e)(2) of this Release (describing possible arrangements for continued payment to investment pools even after a time out is triggered).

126 *See, e.g.*, Comment Letter of Davis Polk & Wardwell LLP (Oct. 6, 2009) ("Davis Polk Letter") (recommending that three months would be reasonable); ICI Letter (suggesting 30 days). Other commenters raised concern regarding the potential harm of a time out to government investors for whom identifying new managers may be a lengthy process. *See, e.g.*, NASP Letter. We believe, however, that, on balance, pension funds and their beneficiaries are best served by the rule's deterrent effect against engaging in pay to play activities. An adviser's fiduciary obligations to continue to provide services for a reasonable amount of time, combined with the extended compliance dates described in section III of this Release which should afford the ability of market participants to

Few of the commenters who opposed this provision appeared to favor its elimination, which would require the adviser to immediately cease providing advisory services upon making a triggering contribution.[128] Rather, they appeared to oppose the two-year time out more generally.[129]

We are not persuaded by their arguments. We believe the prohibition on compensation is both appropriate and administrable. The incentives to engage in pay to play may be significant, precisely because of the long-term nature of many advisory relationships from which the adviser could benefit for several years. As a result, the consequences of engaging in pay to play need to be commensurate with these incentives for the prophylactic rule to have a meaningful deterrent effect.[130] We acknowledge that the rule will involve compliance costs and could adversely affect an adviser's business.[131] On the other hand, a political contribution would not affect the ability of an adviser to provide compensated services to other clients, including other government clients.

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organize themselves in a way to adapt to the rule's requirements, should be sufficient to minimize the impact on pension plans to the extent they need to prepare to transition to a new money manager after a two-year time out is triggered.

127 Jones Day Letter. Other commenters argued that the specter of a two-year time out might cause some firms to ban or require pre-clearance of all employees' contributions. *See, e.g.*, Caplin & Drysdale Letter. Although the rule does not require this approach, as a result of commenters' assertions, we address this possibility in our cost-benefit analysis. *See* section IV of this Release.

128 *See, e.g.,* Davis Polk Letter; ICI Letter.

129 *See, e.g.*, National Organizations Letter; ICI Letter; Jones Day Letter; Dechert Letter.

130 This deterrent effect is the basis for our view that the two-year time out should not apply only to "new business" and that advisers should not be able to "negotiate" for lesser consequences. *See supra* note 124 (pointing to commenters who called for more flexibility regarding the two-year time out). As we point out above, our concerns extend to contributions designed to enable advisers to retain contracts that might not otherwise be renewed.

131 For a discussion of costs and other burdens that may be imposed by our rule, see generally sections IV-V of this Release.

Moreover, the fiduciary obligations of an adviser would not require it to provide uncompensated advice indefinitely—rather, the adviser may need to continue to provide advice for only a reasonable period of time during which its client can seek to obtain advisory services from others.[132]

Some commenters urged us to permit advisers to continue to receive compensation during the two-year time out for services provided pursuant to an existing management contract,[133] without distinguishing whether the contract was acquired as a result of political contributions. One commenter further suggested specifically that we permit advisory services to continue to be provided by the adviser at cost during the time out to remove the profit motive of pay to play.[134] We are also not persuaded by their suggestions. Allowing contracts acquired as a result of political contributions to continue uninterrupted would eviscerate the rule. Were a "free pass" available for contracts

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[132] *See supra* note 122 and accompanying text. The amount of time a client might need in good faith to find and engage a successor to the adviser would, in our view, be the primary consideration of the length of a reasonable period, which may depend in part on such matters as applicable law, the client's customary process of finding and engaging advisers and the types of assets managed by the adviser that is subject to the time out. In some cases, a client may be able to quickly engage a "transition adviser" to manage its assets until a permanent successor is found. *See, e.g.*, *Illinois State Board Sets Transition Manager RFP*, PENSIONS & INVESTMENTS, Feb. 8, 2010 *available at* http://www.pionline.com/article/20100208/PRINTSUB/302089976. In other cases, the client may be required by the law under which it operates to undertake a specified process to obtain a new manager, such as a solicitation for proposals from potential managers.

[133] *See, e.g.*, Dechert Letter; Fidelity Letter; ICI Letter; Jones Day Letter (in some instances, pointing to the MSRB's approach of not necessarily applying MSRB rule G-37's two-year time out when a contribution is made after a business contract is signed). *See* MSRB, *Interpretation on the Effect of a Ban on Municipal Securities Business under Rule G-37 Arising During a Pre-Existing Engagement Related to Municipal Fund Securities*, MSRB Rule G-37 Interpretive Notice (April 2, 2002), *available at* http://msrb.org/msrb1/archive/ContributionsNotice.htm). As we explain above, due to the long-term nature of typical advisory contracts and our belief that the consequences of giving a contribution need to be commensurate with the potential benefits obtained, we are not taking this approach.

[134] Dechert Letter.

merely because they were entered into prior to discovery of a contribution, advisers would be strongly incentivized against "discovering" contributions.[135] Because no new business from a government client may even be available to the adviser until the two-year period has run its course, advisers whose contributions succeeded in acquiring a management contract for two years or more could escape any consequences under such an exception.[136] Further, in our judgment, the potential loss of profits will not operate as an adequate deterrent. It is our understanding that being selected to manage public pension plan assets has a reputational value that itself contributes to advisory profits by attracting additional assets under management regardless of the profits derived directly from the management of government client assets.[137]

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135 An approach that applied the two-year time out only to new business would preclude the adviser from receiving compensation only from additional contracts that *might* be awarded by the government entity during the two-year period. In our judgment, the risk of the potential loss of additional advisory contracts for a two-year period would provide an inadequate deterrent to contributions designed to influence the award of such additional advisory contracts.

136 We are concerned that limiting application of the rule to new business could invite abuse. For example, pension officials seeking contributions after a contract has been awarded could attempt to offer an adviser additional assets to manage under the existing contract with the condition that the adviser subsequently make political contributions.

137 *See, e.g.*, Kevin McCoy, *Do Campaign Contributions Help Win Pension Fund Deals*, USA TODAY, Aug. 28, 2009, *available at* http://www.usatoday.com/money/perfi/funds/2009-08-26-pension-fund-political-donations_N.htm (referring to advisory firms winning management mandates from pension funds, stating: "The awards generate lucrative fees and lend prestige that could help lure new clients."); Louise Story, *Quadrangle Facing Questions Over Pension Funds*, N.Y. TIMES, Apr. 21, 2009, *available at* http://www.nytimes.com/2009/04/22/business/22quadrangle.html (highlighting an indirect benefit of a pension fund investment, stating: "the prestige associated with it helped the firm lure other big investors.").

(2) Officials of a Government Entity

The rule's two-year time out is triggered by a contribution to an "official" of a "government entity."[138] An official includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.[139] Government entities include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457, and 529 plans.[140]

The two-year time out is thus triggered by contributions, not only to elected officials who have legal authority to hire the adviser, but also to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser. We have not modified this approach from our proposal.[141] As we noted in the Proposing Release, a person appointed by an elected official is likely to be subject to that official's

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138 Rule 206(4)-5(a)(1) makes it unlawful for covered investment advisers to provide investment advisory services for compensation to a government entity within two years after a contribution to an *official* of the *government entity* is made by the investment adviser or any of its covered associates.

139 Rule 206(4)-5(f)(6). For purposes of the rule, we would not interpret the definition of "official" as covering an individual who is also a "covered associate" of the adviser. Accordingly, under the rule, a covered associate who is an incumbent or candidate for office is not limited to contributing the *de minimis* amount to his or her own campaign. The MSRB takes a similar view with respect to its rule G-37. MSRB, *Questions and Answers Concerning Political Contributions and Prohibitions on Municipal Securities Business: Rule G-37,* MSRB rule G-37 Interpretive Notice, *available at* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx ("MSRB Rule G-37 Q&A"), Question II.10 (May 24, 1994).

140 Rule 206(4)-5(f)(5).

141 *See* Proposing Release, at section II.A.3(a)(2).

influences and recommendations.[142] It is the scope of authority of the particular *office* of an official, not the influence actually exercised by the individual, that would determine whether the individual has influence over the awarding of an investment advisory contract under the definition.[143] We are adopting these provisions as proposed.[144]

Some commenters asserted that the rule should be more specific as to which public officials to whom a contribution is made would trigger application of the rule in order to reduce uncertainty and compliance burdens.[145] But state and municipal statutes vary substantially with respect to whom they entrust with the management of public

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142 *Id.*

143 As such, executive officers or legislators whose official position gives them the authority to influence the hiring of an investment adviser generally would be "government officials" under the rule. For example, a state may have a pension fund whose board of directors, which has authority to hire an investment adviser, is constituted, at least in part, by appointees of the governor and members of the state legislature. *See, e.g.*, The Commonwealth of Pennsylvania Public School Employees' Retirement Board, *Statement of Organization, By-Laws and Other Procedures* (rev. Jun. 11, 2009), art. II, sec. 2.1, *available at* http://www.psers.state.pa.us/org/board/policies/201001_bylaws.pdf (noting that the board shall be composed of, *inter alia*, two persons appointed by the Pennsylvania State Governor, two Pennsylvania state senators and two members of the Pennsylvania state house of representatives). In such circumstances, the governor and the members of the state legislature serving on the board would be officials of the government entity. Conversely, a public official who is tasked with performing an audit of the selection process but has no influence over hiring outcomes would not be an official of a government entity for purposes of the rule.

144 These definitions and their application are substantively the same as those in MSRB rule G-37. *See* MSRB rule G-37(g)(ii) and (g)(vi).

145 *See, e.g.*, IAA Letter; NSCP Letter; Comment Letter of T. Rowe Price Associates, Inc. (Oct. 6, 2009) ("T. Rowe Letter"); MFA Letter; Davis Polk Letter. For a discussion of the potential costs involved in identifying officials to whom contributions could trigger the rule's prohibitions, see section IV of this Release (presenting our cost-benefit analysis). Another commenter suggested that advisers should be able to rely on certifications from candidates and officials regarding whether their office would render them an "official" for purposes of the rule—*i.e.*, identifying the range, if any, of public investment vehicles over which the relevant office directly or indirectly influences the selection of investment advisers or appoints individuals who do). Caplin & Drysdale Letter. We are concerned that such a safe harbor would undercut the purposes of the rule, not least because officials will be incentivized to offer such certifications liberally (and will presumably sometimes do so inappropriately) to encourage contributions.

funds, and any effort we make in a rule of general application to identify specific officials who are in a position to influence the selection of an adviser would certainly be over-inclusive in some circumstances and under-inclusive in others.[146] Others urged that triggering contributions should be limited to contributions to officials directly responsible for the selection of advisers.[147] Excluding from the application of the rule contributions to those who are in a position to *indirectly* influence the selection of an investment adviser could simply lead officials to re-structure their relationships to avoid application of the rule to advisers that may contribute to those officials.

Two commenters argued that the rule should not cover contributions to candidates for federal office,[148] while another contended that it should.[149] Under our rule, as proposed, a candidate for federal office could be an "official" under the rule not because of the office he or she is running for, but as a result of an office he or she currently holds.[150] So long as an official has influence over the hiring of investment advisers as a function of his or her current office, contributions by an adviser could have the same effect, regardless to which of the official's campaigns the adviser contributes. For that

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146 Like us, the MSRB does not specify which officials have the authority to influence the granting of government business for purposes of its rule G-37. *See* MSRB, *Campaign for Federal Office*, MSRB Rule G-37 Interpretive Notice (May 31, 1995), *available at* http://msrb.org/msrb1/rules/interpg37.htm ("The Board does not make determinations concerning whether a particular individual meets the definition of "official of an issuer.").

147 *See, e.g.*, IAA Letter; NASP Letter; NY City Bar Letter; Davis Polk Letter.

148 *See, e.g.*, NSCP Letter; Dechert Letter.

149 Fund Democracy/Consumer Federation Letter.

150 As a result, if a state or municipal official were, for example, a candidate for the U.S. Senate, House of Representatives, or presidency, an adviser's contributions to that official would be covered by the rule. MSRB rule G-37's time out provision is also triggered by contributions to state and local officials running for federal office. *See* MSRB Rule G-37 Q&A, Questions IV.2-3.

reason, we are not persuaded that an incumbent state or local official should be excluded from the definition solely because he or she is running for federal office.[151]

(3) Contributions

The rule's time out provisions are triggered by *contributions* made by an adviser or any of its covered associates.[152] A contribution is defined to include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such an election.[153] It also includes transition or inaugural expenses incurred by a successful candidate for state or local office.[154] The definition is the same as we proposed and as the one used in MSRB rule G-37.[155]

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151 Under certain circumstances, a state or municipal official running for federal office could remove herself from being an "official" for purposes of rule 206(4)-5 by eliminating her ability to influence the outcome of the hiring of an investment adviser. This might occur, for example, if she were to: (i) formally withdraw from participation in or influencing adviser hiring decisions; (ii) be leaving office, so that he or she could not participate in subsequent decision-making; and (iii) have held direct influence over the adviser hiring process (as opposed to, for example, having designated an appointee with such influence who would remain in a position to influence such hiring).

152 Rule 206(4)-5(a)(1) makes it unlawful for covered investment advisers to provide investment advisory services for compensation to a government entity within two years after a *contribution* to an official of the government entity is made by the investment adviser or any of its covered associates. As suggested above, we are concerned that contributions may be used "as the cover for what is much like a bribe: a payment that accrues to the private advantage of the official and is intended to induce him to exercise his discretion in the donor's favor, potentially at the expense of the polity he serves." *Blount*, 61 F.3d at 942 (describing the Commission's approval of MSRB rule G-37 as based on a wish to curtail this function).

153 Rule 206(4)-5(f)(1).

154 MSRB rule G-37 also covers payment of transition or inaugural expenses as contributions for purposes of its time out provision. *See* MSRB Rule G-37 Q&A, Question II.6. However, under neither rule does a contribution include the transition or inaugural expenses of a successful candidate for *federal* office. Contributions to political parties are not specifically covered by the definition and thus would not trigger the rule's two-year time out unless they are a means to do indirectly what the rule prohibits if done directly (for example, the contributions are earmarked or known to be provided for the benefit of a particular political official). We also note that "contributions" are not intended to include independent "expenditures," as that term is defined in 2 U.S.C. 431 &

We received requests that we clarify the application of the rule to some common circumstances that may arise in the course of an adviser's relationship with a government client.[156] We would not consider a donation of time by an individual to be a contribution, provided the adviser has not solicited the individual's efforts and the adviser's resources, such as office space and telephones, are not used.[157] Similarly, we would not consider a charitable donation made by an investment adviser to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code,[158] or its equivalent in a foreign jurisdiction, at the request of an official of a government entity to be a contribution for purposes of rule 206(4)-5.[159]

441b (the federal statutory provisions limiting contributions and expenditures by national banks, corporations, or labor organizations invalidated by *Citizens United v. Federal Election Commission*, 130 S. Ct. 876 (2010) (holding that corporate funding of independent political broadcasts in candidate elections cannot be limited under the First Amendment)). Indeed, it is our intent that, under the rule, advisers and their covered associates "are not in any way restricted from engaging in the vast majority of political activities, including making direct expenditures for the expression of their views, giving speeches, soliciting votes, writing books, or appearing at fundraising events." *Blount*, 61 F.3d at 948.

155 MSRB rule G-37(g)(i).

156 *See, e.g.*, Caplin & Drysdale Letter; Callcott Letter I (volunteer activities); NASP Letter (charitable contributions); Sutherland Letter; IAA Letter (entertainment expenses and conference expenses). We address entertainment and conference expenses in section II.B.2(c) of this Release (which discusses the prohibition on soliciting or coordinating contributions from others).

157 *See* Proposing Release, at n.91. A covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the adviser is not otherwise paying the employee's salary (*e.g.*, an unpaid leave of absence). *But see* rule 206(4)-5(d) (prohibiting an adviser from doing indirectly what the rule would prohibit if done directly). The MSRB deals similarly with this issue. *See* MSRB Rule G-37 Q&A, Question II.19.

158 Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. 501(c)(3)) contains a list of charitable organizations that are exempt from federal income taxation.

159 The MSRB deals similarly with this issue. *See* MSRB Rule G-37 Q&A, Question II.18. *But see* rule 206(4)-5(d) (prohibiting an adviser from doing indirectly what the rule would prohibit if done directly).

The few commenters that addressed the definition of "contribution" generally urged us to adopt a narrower version. Some, for example, recommended that contributions be expressly limited to political contributions and more explicitly exclude expenditures not clearly made for the purpose of influencing an election.[160] We are not narrowing our definition. We are instead adopting our definition as proposed due to our concern that "contributions" may also take the form of payment of election-related debts and transition or inaugural expenses. Further, our definition of "contribution" already requires that the payment be made for the purpose of influencing an election for a federal, state or local office.[161] We believe that the scope of our proposed definition is appropriate in light of the conduct we are seeking to address.

Commenters were divided as to whether contributions to PACs or local political parties should trigger the two-year time out.[162] Such contributions were not explicitly covered by the proposed rule and do not necessarily trigger the two-year time out in MSRB rule G-37.[163] In some cases, such contributions may effectively operate as a

160 *See, e.g.*, National Organizations Letter; NASP Letter.

161 Rule 206(4)-5(f)(1).

162 *See, e.g.*, CalPERS Letter; NSCP Letter (should not apply to contributions to PACs or state or local parties, unless a particular candidate directly solicits contributions for those entities); Comment Letter of James J. Reilly (Aug. 24, 2009) ("Reilly Letter") (contributions to political parties should be included because in state and local elections contributions to political parties may effectively amount to contributions to an individual candidate); SIFMA Letter.

163 *See, e.g.*, MSRB, *Payments to Non-Political Accounts of Political Organizations*, MSRB rule G-37 Interpretive Letter (Sept. 25, 2007), *available at* http://msrb.org/msrb1/rules/interpg37.htm (explaining that not all payments to political organizations that, in turn, make contributions to officials trigger Rule G-37's time out). With regard to solicitations from a PAC or a political party with no indication of how the collected funds will be disbursed, advisers should inquire how any funds received from the adviser or its covered associates would be used. For example, if the PAC or political party is soliciting funds for the purpose of supporting a limited number of government officials, then, depending upon the facts and circumstances, contributions to the PAC or payments to the political party might well result in the same prohibition on compensation

funnel to the campaigns of the government officials.[164] In other cases, however, they may fund general party political activities or the campaigns of other candidates.[165] Therefore, we have decided not to explicitly include all such contributions among those that trigger the time out, although they may violate the provision of the rule, discussed below, which prohibits an adviser or any of its covered persons from indirect actions that would result in a violation of the rule if done directly.[166]

The MSRB rule G-37 definition of "contribution" has, in our view, proved to be workable. The types of contributions relevant to money managers and elected officials are unlikely to be different than those made to influence the awarding of municipal securities business by broker-dealers. On balance, we believe that the MSRB's definition of "contribution," which we mirrored in our proposal, achieves the goals of this rulemaking. Therefore, we are adopting the definition as proposed.

(4) Covered Associates

Contributions made to influence the selection process are typically made not by the firm itself, but by officers and employees of the firm who have a direct economic stake in the business relationship with the government client.[167] Accordingly, under the

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for providing investment advisory services to a government entity as would a contribution made directly to the official. Our approach is consistent with the MSRB's. *See* MSRB Rule G-37 Q&A, Question III.5.

164 *See, e.g.*, Reilly Letter.

165 *See, e.g.*, Caplin & Drysdale Letter (explaining that "leadership PACs," for example, are commonly established by officeholders to donate to other candidates and issues).

166 *See* section II.B.2(d) of this Release. For the MSRB's approach to this issue, see MSRB Rule G-37 Q&A, Question III.4. *But see* rule 206(4)-5(d) (noting that the rule's definition of "official" of a government entity includes any election committee for that person).

167 Proposing Release, at section II.A.3(a)(4). Based on enforcement actions, we believe that such persons are more likely to have an economic incentive to make contributions to influence the advisory firm's selection. *See id.*

rule, contributions by each of these persons, which the rule defines as "covered associates," trigger the two-year time out.[168] A "covered associate" of an investment adviser is defined as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any of its covered associates.[169]

Owners. Contributions by sole proprietors are contributions by the adviser itself.[170] If the adviser is a partnership, the rule covers contributions by the adviser's general partners.[171] If the adviser is a limited liability company, the rule covers contributions made by managing members.[172] A contribution by an owner that is a limited partner or non-managing member (of a limited liability company) is not covered, however, unless the limited partner or non-managing member is also an executive officer or solicitor (or person who supervises a solicitor) covered by the rule, or unless the contribution is an indirect contribution by the adviser, executive officer, solicitor, or supervisor.[173] Similarly, if the adviser is a corporation, shareholder contributions are not covered unless the shareholder is also an executive officer or solicitor covered by the

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168 Rule 206(4)-5(a)(1).

169 Rule 206(4)-5(f)(2).

170 We note, however, that a sole proprietor may, in a personal capacity, avail herself or himself of the *de minimis* exceptions described in section II.B.2(a)(6) of this Release.

171 Rule 206(4)-5(f)(2)(i).

172 *Id.*

173 *See* rule 206(4)-5(a)(1), (d) and (f)(2)(i)-(ii).

rule, or unless the contribution is an indirect contribution by the adviser, executive officer, solicitor, or supervisor.[174]

Executive Officers. Contributions by an executive officer of an investment adviser trigger the two-year time out.[175] Executive officers include: (i) the president; (ii) any vice president in charge of a principal business unit, division or function (such as sales, administration or finance); (iii) any other officer of the investment adviser who performs a policy-making function; or (iv) any other person who performs similar policy-making functions for the investment adviser.[176] Whether a person is an executive officer depends on his or her function, not title; for example, an officer who is the chief executive of an advisory firm but whose title does not include "president" is nonetheless an executive officer for purposes of the rule.

The definition reflects changes we have made from our proposal that are designed to clarify the rule and to tailor it to apply to those officers of an investment adviser whose position in the organization is more likely to incentivize them to obtain or retain clients for the investment adviser (and, therefore, to engage in pay to play practices) while still achieving our objectives. We have clarified that "other executive officers" under the rule—*i.e.*, those other than the president and vice presidents in charge of principal business units or functions—include only those officers or other persons who perform a policy-making function for the investment adviser.[177] This limitation, which was

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[174] *Id.*

[175] The definition of "covered associate" includes, among others, any executive officer or other individual with a similar status or function. Rule 206(4)-5(f)(2)(i).

[176] Rule 206(4)-5(f)(4).

[177] Rule 206(4)-2(f)(4). This modification also aligns the definition more closely with the definition of "executive officer" in our other rules. *See, e.g.*, rule 205-3(d)(4) under the Advisers Act [17 CFR 275.205-3(d)(4)] (defining executive officer for purposes of

recommended by commenters,[178] excludes persons who enjoy certain titles as a formal matter but do not engage in the kinds of activities that we believe should trigger the prohibitions in the rule.[179] We have also modified the definition to remove the limitation that the officer, as part of his or her regular duties, performs or supervises any person who performs advisory services for the adviser, or solicits or supervises any person who solicits for the adviser. We agree with the commenter who asserted that "... all of the adviser's executive officers should be included because the nature of their status alone

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determinations of who is a qualified client exempting an adviser from the prohibition on entering into, performing, renewing or extending an investment advisory contract that provides for compensation on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, under the Advisers Act) and rule 3c-5(a)(3) [17 CFR 270.3c-5(a)(3)] under the Investment Company Act of 1940 [15 U.S.C. 80a] ("Investment Company Act") (defining executive officer for purposes of determinations of the number of beneficial owners of a company excluded from the definition of "investment company" by section 3(c)(1) of the Investment Company Act, and whether the outstanding securities of a company excluded from the definition of "investment company" by section 3(c)(7) of the Investment Company Act are owned exclusively by qualified purchasers, as defined in that Act). It also more closely aligns the definition to the MSRB approach. *See* MSRB rule G-37(g)(v).

178 *See, e.g.*, Sutherland Letter.

179 Several commenters urged us expressly to exclude from the definition the CEO, officers and employees of a parent company. *See, e.g.*, SIFMA Letter; ICI Letter; MFA Letter; Skadden Letter. Depending on facts and circumstances, there may be instances in which a supervisor of an adviser's covered associate (who, for example, engages in solicitation of government entity clients for the adviser) formally resides at a parent company, but whose contributions should trigger the two-year time out because they raise the same conflict of interest issues that we are concerned about, irrespective of that person's location or title. In other words, whether a person is a covered associate ultimately depends on the activities of the individual and not his or her title. We recently considered a similar issue in a report addressing whether MSRB rule G-37 could include contributions by employees of parent companies as triggering that rule's time out provision, see *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: JP Morgan Securities, Inc.*, Exchange Act Release No. 61734 (Mar. 18, 2010), *available at* http://www.sec.gov/litigation/investreport/34-61734.htm ("This Report serves to remind the financial community that placing an executive who supervises the activities of a broker, dealer or municipal securities dealer outside of the corporate governance structure of such broker, dealer or municipal securities dealer does not prevent the application of MSRB Rule G-37 to that individual's conduct."). The MSRB also takes the view that it is an individual's activities and not his or her title that may render his or her contributions a trigger for that rule's time out provision. *See* MSRB Rule G-37 Q&A, Question IV.18.

creates a strong incentive to engage in pay to play practices."[180] Even if these senior officers are not directly involved in advisory or solicitation activities, as part of senior management, their success within the advisory firm is likely to be tied to the firm's success in obtaining clients.[181]

Employees who Solicit Government Clients. Contributions by any employee who solicits a government entity for the adviser would trigger the two-year time out.[182] An employee need not be primarily engaged in solicitation activities to be a "covered associate" under the rule.[183] We are also including persons who supervise employees who solicit government entities because we believe these persons are strongly incentivized to engage in pay to play activities to obtain government entity clients.[184] We

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180 *See* Fund Democracy Letter.

181 Commenters also suggested that our definition exclude vice presidents in charge of business units, divisions or functions whose function is unrelated to investment advisory or solicitation activities. *See, e.g.*, IAA Letter. For the reasons described above, we do not believe such an exclusion is appropriate.

182 We are not adopting the suggestion of several commenters that we treat third-party solicitors the same way as employees. *See, e.g.*, 3PM Letter; Triton Pacific Letter; Comment Letter of Arrow Partners, Inc. Partner Ken Rogers (Sept. 2, 2009) ("Arrow Letter"). We explained in the Proposing Release that we determined not to propose this approach out of concern for the difficulties that advisers may have when monitoring the activities of their third-party solicitors. *See* Proposing Release, at nn.135 and accompanying text. Commenters did not persuade us that these concerns can reasonably be expected to be overcome. Therefore, whereas contributions by covered associates of the adviser trigger the two-year compensation time out, an adviser is prohibited from hiring third parties to solicit government business on its behalf unless the third party is a "regulated person." *See* section II.B.2(b) of this Release. Our approach is similar to MSRB's rule G-38, which restricts third-party solicitation activities differently from the two-year time out. *See* MSRB rule G-38.

183 The MSRB also takes the approach that an associated person need not be "primarily engaged" in activities that would make his or her contributions trigger rule G-37's time out provision, particularly where he or she engages in soliciting business. *See* MSRB Rule G-37 Q&A, Question IV.8.

184 Rule 206(4)-5(f)(2)(ii). The proposed rule would only have applied to *senior officers* who supervise employee solicitors. *See* proposed rule 206(4)-5(f)(4)(ii). MSRB rule G-37 also applies to supervisors of persons who solicit relevant business from government entities. *See* MSRB Rule G-37 Q&A, Question IV.14.

have revised this aspect of the definition to include *all* supervisors of those solicitors that solicit government entities because we believe the incentives to engage in pay to play exist for all such supervisors, not just those that have a certain level of seniority.

Rule 206(4)-5 defines "solicit" to mean, with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser.[185] Commenters asked us to provide further guidance on what we mean by "solicit."[186] The determination of whether a particular communication is a solicitation is dependent upon the specific facts and circumstances relating to such communication. As a general proposition any communication made under circumstances reasonably calculated to obtain or retain an advisory client would be considered a solicitation unless the circumstances otherwise indicate that the communication does not have the purpose of obtaining or retaining an advisory client. For example, if a government official asks an employee of an advisory firm whether the adviser has pension fund advisory capabilities, such employee generally would not be viewed as having solicited advisory business if he or she provides a limited affirmative response, together with either providing the government official with contact information for a covered associate of the adviser or informing the government official that advisory personnel who handle government advisory business will contact him or her.[187]

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185 Rule 206(4)-5(f)(10)(i). We are adopting this definition as proposed.

186 *See, e.g.,* Skadden Letter.

187 Similarly, if a government official is discussing governmental asset management issues with an employee of an adviser, the employee generally would not be viewed as having solicited business if he or she provides a limited communication to the government official that such alternative may be appropriate, together with either providing the government official with contact information for a covered associate or informing the

Political Action Committees. A covered associate includes a political action committee controlled by the investment adviser or by any of its covered associates.[188] Under the rule, we would regard an adviser or its covered associate to have "control" over a political action committee if the adviser or its covered associate has the ability to direct or cause the direction of the governance or operations of the PAC.[189]

Two commenters asserted that we should narrow the definition of "covered associate" with respect to political action committees.[190] Specifically, they asserted that the definition should only include PACs controlled by the adviser and not those controlled by other covered associates, which could be a separate legal entity over which

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government official that advisory personnel who handle asset management for government clients will contact him or her. In these examples, however, if the adviser's employee receives compensation such as a finder's or referral fee for such business or if the employee engages in other activities that could be deemed a solicitation with respect to such business, the employee generally would be viewed as having solicited the advisory business. Our interpretation of what it means to "solicit" government business is consistent with the MSRB's. *See* MSRB, *Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), *available at* http://msrb.org/msrb1/rules/notg38.htm.

188 Rule 206(4)-5(f)(2)(iii) (which we are adopting as proposed). One commenter suggested that we define a "political action committee," or PAC, as any organization required to register as a political committee under federal, state or local law. Caplin & Drysdale Letter. But we have not included this definition of PAC because we do not believe a definition linked to the registration status of a political committee would serve our purpose of deterring evasion of the rule as registration requirements vary among election laws. We note, however, that we would construe the term PAC to include (but not necessarily be limited to) those political committees generally referred to as PACs, such as separate segregated funds or non-connected committees within the meaning of the Federal Election Campaign Act, or any state or local law equivalent. *See* Federal Election Commission, Quick Answers to PAC Questions, *available at* http://www.fec.gov/ans/answers_pac.shtml#pac. Determination of whether an entity is a PAC covered by our rule would not, in our view, turn on whether the PAC was, or was required to be, registered under relevant law.

189 One commenter suggested a similar interpretation of "control." Caplin & Drysdale Letter. For the MSRB's approach to this definition, see MSRB Rule G-37 Q&A, Question IV.24.

190 SIFMA Letter; Sutherland Letter.

the adviser may have little influence.[191] We are not adopting this suggestion. As we discussed in the Proposing Release, PACs are often used to make political contributions.[192] The recommended changes would permit an executive of the adviser or another covered person of the adviser to use a PAC he or she controls to evade the rule. Even where the adviser itself does not control such PACs directly, we are concerned about their use to evade our rule where they are controlled by covered associates (whose positions in the organization, as we note above, are more likely to incentivize them to obtain or retain clients for the investment adviser).[193]

Other Persons. Several commenters urged that our definitions be broadened to encompass other persons whose contributions should trigger the two-year time out.[194] One urged that in some cases all employees should be covered associates because of the likelihood they could directly benefit from engaging in pay to play.[195] Another urged that the definition of covered associate include affiliates of the adviser that solicit government business on the adviser's behalf, any director of the adviser, and any significant owner of the adviser.[196] These suggestions would expand the rule to a range of persons that could

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191 *Id.*

192 Proposing Release, at n.101.

193 Advisers are responsible for supervising their supervised persons, including their covered associates. We have the authority to seek sanctions where an investment adviser, or an associated person, has failed reasonably to supervise, with a view to preventing violations of the federal securities laws or rules, a person who is subject to the adviser's (or its associated person's) supervision and who commits such violations. Sections 203(e)(6) and 203(f) of the Advisers Act [15 U.S.C. 80b-3(e)(6) and (f)].

194 *See, e.g.*, Fund Democracy/Consumer Federation Letter; DiNapoli Letter (suggesting the rule also cover contributions from family members); Ounavarra Letter.

195 Ounavarra Letter.

196 Fund Democracy/Consumer Federation Letter.

engage in pay to play activities.[197] In our judgment, however, contributions from these types of persons are less likely to involve pay to play unless the contributions were made by these persons for the purpose of avoiding application of the rule, which could result in the adviser's violation of a separate provision of the rule.[198] We do not believe that the incremental benefits of capturing conduct of other individuals less likely to engage in pay to play based on the record before us today outweigh the additional burden such an expansion would impose.[199] Thus, we are not expanding the definition as these commenters have suggested.

Other commenters urged us to narrow our definition of "covered associate" to include fewer persons.[200] For example, one commenter recommended that the definition of "covered associate" expressly exclude all "support personnel."[201] Another suggested that we limit the definition to those who solicit government clients with a "major purpose" of obtaining that government client.[202] Expressly excluding all "support personnel" is unnecessary because, in almost all cases, such persons would not be

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197 *See, e.g.*, *supra* note 179 (discussing why we have chosen not to limit the definition of "executive officer" in other ways as suggested by some commenters).

198 *See* Rule 206(4)-5(d). We also note that the MSRB takes a similar approach. *See, e.g.*, MSRB Rule G-37 Q&A, Question IV.9 (noting that the universe of those whose contributions above the *de minimis* level *per se* trigger the two-year time out is limited and does not include their consultants, lawyers or spouses). The MSRB also leaves contributions by affiliates and personnel beyond those identified as triggering the two-year time out to be addressed by a provision prohibiting municipal securities dealers from doing indirectly what they are prohibited from doing directly under rule G-37. *See* MSRB Rule G-37(d).

199 In this instance, as in others, we are sensitive to First Amendment concerns that further expansion of the scope of covered associates could broaden the rule's scope beyond what is necessary to accomplish its purposes.

200 *See, e.g.*, T. Rowe Price Letter; NSCP Letter; Skadden Letter.

201 T. Rowe Price Letter.

202 Skadden Letter.

"covered associates," as that term is defined in the rule. We have not limited the definition to those who solicit government clients with a "major purpose" of obtaining that government client because we believe that our rule's definition of "solicit," as discussed above, adequately takes into account the purpose of the communication and adding an additional element of intent may exclude employees who have an incentive to engage in pay to play practices.

(5) "Look Back"

The rule attributes to an adviser contributions made by a person within two years (or, in some cases, six months) of becoming a covered associate of that adviser.[203] In other words, when an employee becomes a covered associate, the adviser must "look back" in time to that employee's contributions to determine whether the time out applies to the adviser.[204] If, for example, the contribution were made more than two years (or, pursuant to the exception described below for non-solicitors, six months) prior to the employee becoming a covered associate, the time out has run; if the contribution was made less than two years (or six months) from the time the person becomes a covered associate, the rule prohibits the adviser that hires or promotes the contributing covered associate from receiving compensation for providing advisory services from the hiring or

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203 Rule 206(4)-5(a)(1). The "look back" applies to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the rule. A person becomes a covered associate for purposes of the rule's look-back provision at the time he or she is hired or promoted to a position that meets the definition of "covered associate" in rule 206(4)-5(f)(2). For a discussion of the definition of "covered associate," see section II.B.2(a)(4) of this Release.

204 Rule 206(4)-5(a)(1) (including among those covered associates whose contributions can trigger the two-year time out a person who becomes a covered associate within two years after the contribution is made); Rule 206(4)-5(b)(2) (excepting from the two-year look back those contributions made by a natural person more than six months prior to becoming a covered associate of the investment adviser unless such person, after becoming a covered associate, solicits clients on behalf of the investment adviser).

promotion date until the two-year period has run.[205] The look-back provision, which is similar to that in MSRB rule G-37, is designed to prevent advisers from circumventing the rule by influencing the selection process by hiring persons who have made political contributions.[206]

We received many comments on our proposed look-back provision,[207] which would have applied the two-year look back with respect to all contributions of new covered associates.[208] One commenter asserted that such a provision is necessary to prevent advisers from circumventing the prohibitions on pay to play.[209] Most commenters, however, argued that the rule should not contain a look-back provision or should contain a shorter one because it could prevent advisers from hiring qualified

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205 In no case would the prohibition imposed by the rule be longer than two years from the date the covered associate makes a covered contribution. If, for example, a covered associate becomes employed by an investment adviser (and engages in solicitation activity for it) one year and six months after making a contribution, the new employer would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. We also note that the rule's exemptive process may be available in instances where an adviser believes application of the look-back provision would yield an unintended result. Rule 206(4)-5(e). For a discussion of the rule's exemptive provision, see section II.B.2(f) of this Release.

206 Similarly, to prevent advisers from channeling contributions through departing employees, advisers must "look forward" with respect to covered associates who cease to qualify as covered associates or leave the firm. The covered associate's employer at the time of the contribution would be subject to the proposed rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate or remains employed by the adviser. Thus, dismissing a covered associate would not relieve the adviser from the two-year time out. MSRB rule G-37 also includes a "look-forward provision." *See* MSRB Rule G-37 Q&A, Question IV.17 (". . . any contributions by [an] associated person [who leaves the dealer's employ] (other than those that qualify for the *de minimis* exception under Rule G-37(b)) will subject the dealer to the rule's ban on municipal securities business for two years from the date of the contribution").

207 *See, e.g.*, Fund Democracy/Consumer Federation Letter; ICI Letter; Davis Polk Letter; NY City Bar Letter; Fidelity Letter; Wells Fargo Letter; MFA Letter; IAA Letter; NASP Letter; American Bankers Letter; Comment Letter of Seward & Kissel LLP (Oct. 6. 2009) ("Seward & Kissel Letter"); Park Hill Letter; Dechert Letter; Skadden Letter.

208 *See* Proposing Release, at section II.A.3(a)(5).

209 Fund Democracy/Consumer Federation Letter.

individuals who have made unrelated political contributions,[210] or it could be disruptive to public pension plans seeking to hire qualified managers.[211] While some urged that we eliminate the look-back provision altogether,[212] most asked us to shorten the period to three to six months.[213] Others suggested alternative approaches to the look back, including adopting a higher contribution threshold to trigger the look-back provision[214] or permitting advisers to hire and promote persons to be covered associates who have made prohibited contributions, but not permitting them to solicit government clients or otherwise create firewalls between them and government clients.[215]

Upon consideration of the comments, we believe that applying the full two-year look back to all new covered associates may be unnecessary to achieve the goals of the rulemaking. We are adopting a suggestion offered by several commenters to shorten the look-back period with respect to certain new covered associates whose contributions are less likely to be involved in pay to play.[216] Under an exception to the rule, the two-year

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210 *See, e.g.*, ICI Letter; Davis Polk Letter; NY City Bar Letter; Fidelity Letter; Wells Fargo Letter; MFA Letter.

211 *See, e.g.*, Comment Letter of Connecticut Treasurer Denise L. Nappier (Sept. 10, 2009) ("CT Treasurer Letter"); CalPERS Letter.

212 *See, e.g.*, IAA Letter; ICI Letter; Wells Fargo Letter; NASP Letter; American Bankers Letter; MFA Letter; Seward & Kissel Letter.

213 *See, e.g.*, ICI Letter (three-month look back); IAA Letter (six-month look back); Park Hill Letter (six-month look back); Wells Fargo Letter (six-month look back); Davis Polk Letter (six-month look back); Dechert Letter (six-month look back); MFA Letter (six-month look back).

214 *See, e.g.*, Wells Fargo Letter; NSCP Letter.

215 *See, e.g.*, Comment Letter of Strategic Capital Partners (Oct. 1, 2009) ("Strategic Capital Letter"); Comment Letter of B. Jack Miller (Oct. 3, 2009); Comment Letter of RP Realty Partners, LLC Chief Financial Officer Jerry Gold (Oct. 2, 2009); SIFMA Letter.

216 *See, e.g.*, MFA Letter; Fidelity Letter; Dechert Letter; Wells Fargo Letter; Skadden Letter. The MSRB shortened the look-back period under MSRB rule G-37 to six months for certain municipal finance professionals in response to similar industry concerns about the impact on hiring. *See* MSRB, *Amendments Filed to Rule G-37 Concerning the*

time out is not triggered by a contribution made by a natural person more than six months prior to becoming a covered associate, unless he or she, after becoming a covered associate, solicits clients.[217] As a result, the two-year look back applies only to covered associates who solicit for the investment adviser.[218]

The potential link between obtaining advisory business and contributions made by an individual prior to his or her becoming a covered associate that is uninvolved in solicitation activities is likely more attenuated and therefore, in our judgment, should be subject to a shorter look back. We have modeled this shortened look-back period[219] on the MSRB's six-month look back for certain personnel, which it implemented as a result of feedback it received from dealers that indicated the two-year look back was negatively affecting in-firm transfers and promotions and "preclud[ing] them from hiring individuals

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Exemption Process and the Definition of Municipal Finance Professional (Sept. 26, 2002), *available at* http://www.msrb.org/msrb1/archive/g%2D37902notice.htm.

217 Rule 206(4)-5(b)(2). An adviser is subject to the two-year time out regardless of whether it is "aware" of the political contributions. Thus, statements by prospective employees regarding whether they have made relevant contributions are insufficient to inoculate the adviser, as some commenters urged (*see, e.g.*, IAA Letter; ICI Letter; NSCP Letter; Caplin & Drysdale Letter), to ensure that investment advisers are not encouraged to relax their efforts to promote compliance with the rule's prohibitions. Nonetheless, advisers who advise or are considering advising any government entity should consider requiring full disclosure of any relevant political contributions from covered associates or potential covered associates to ensure compliance with rule 206(4)-5. Advisers are required to request similar reports about securities holdings by Advisers Act rule 204A-1(b)(1)(ii) [17 CFR 275.204A-1(b)(1)(ii)], which requires each of a firm's "access persons" to submit an initial "holdings report" of securities he or she beneficially owns at the time he or she becomes an access person, even though the securities would likely have been acquired in transactions prior to becoming an access person. For a discussion of an adviser's recordkeeping obligations with regard to records of contributions by a new covered associate during that new covered associate's look-back period, see *infra* note 428.

218 *See* rule 206(4)-5(f)(2) (defining covered associate of an investment adviser as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee).

219 *See* rule 206(4)-5(b)(2).

who had made contributions, even though the contributions (which may have been relatively small) were made at a time when the individuals had no reason to be familiar with Rule G-37."[220] This approach balances commenters' concerns about the implications for their hiring decisions with the need to protect against individuals marketing to prospective investment adviser employers their connections to, or influence over, government entities those advisers might be seeking as clients.[221]

(6) Exceptions for De Minimis Contributions

Rule 206(4)-5 permits individuals to make aggregate contributions without triggering the two-year time out of up to $350, per election, to an elected official or candidate for whom the individual is entitled to vote,[222] and up to $150, per election, to

220 MSRB, *Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Amendments to Rules G-37, on Political Contributions and Prohibitions on Municipal Securities Business, G-8, on Books and Records, Revisions to Form G-37/G-38 and the Withdrawal of Certain Rule G-37 Questions and Answers*, Exchange Act Release No. 47609 (April 1, 2003) [67 FR 17122 (Apr. 8, 2003)]. *See also* MSRB, *Self-Regulatory Organizations; Order Granting Approval of a Proposed Rule Change and Amendment No. 1 Thereto by the Municipal Securities Rulemaking Board Relating to Amendments to Rules G-37, on Political Contributions and Prohibitions on Municipal Securities Business, G-8, on Books and Records, Revisions to Form G-37/G-38 and the Withdrawal of Certain Rule G-37 Questions and Answers*, Exchange Act Release No. 47814 (May 8, 2003) [68 FR 25917 (May 14, 2003)] (Commission order approving amendments to MSRB rule G-37); MSRB rule G-37(b)(iii).

221 We are not adopting the suggestion of commenters to exclude from the look-back provision contributions made before a merger or acquisition by an adviser by not attributing the contributions of the acquired adviser to the acquiring adviser. *See, e.g.*, Dechert Letter; ICI Letter. We believe that an acquisition of another adviser could raise identical concerns where the acquired adviser has made political contributions designed to benefit the acquiring adviser. Rule 206(4)-5 is not intended to prevent mergers in the investment advisory industry or, once a merger is consummated, to hinder the surviving adviser's government advisory business unless the merger was an attempt to circumvent rule 206(4)-5. Thus, the adviser may wish to seek an exemption from the ban on receiving compensation pursuant to rule 206(4)-5(a) from the Commission. The MSRB takes the same approach to this issue. *See* MSRB Rule G-37 Q&A, Question II.16.

222 For purposes of rule 206(4)-5, a person would be "entitled to vote" for an official if the person's principal residence is in the locality in which the official seeks election. For example, if a government official is a state governor running for re-election, any covered

an elected official or candidate for whom the individual is not entitled to vote.[223] These *de minimis* exceptions are available only for contributions by individual covered associates, not the investment adviser itself.[224] Under both exceptions, primary and general elections would be considered separate elections.[225]

We proposed a $250 *de minimis* exception for contributions to candidates for whom a covered associate is entitled to vote,[226] which reflects the current *de minimis* exception in MSRB rule G-37.[227] Many commenters urged us to increase the *de minimis* amount (either to a larger number or by indexing it to inflation), arguing that a

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associate of an adviser who resides in that state may make a *de minimis* contribution to the official without causing a ban on that adviser being compensated for providing advisory services for that government entity. In the example of a government official running for President, any covered associate in the country can contribute the *de minimis* amount to the official's Presidential campaign. The MSRB has issued a similar interpretation of what it means to be "entitled to vote" for purposes of MSRB rule G-37. *See MSRB Reports*, Vol. 16. No. 1 (January 1996) at 31-34.

223 *See* Rule 206(4)-5(b)(1) (excepting "*de minimis*" contributions to "officials" (*see supra* note 139 and accompanying text) from the rule's two-year time out provision).

224 *Id.* Under the rule, each covered associate, taken separately, would be subject to the *de minimis* exceptions. In other words, the limit applies per covered associate and is not an aggregate limit for all of an adviser's covered associates. *But see supra* note 170 (pointing out that a sole proprietor may, in a personal capacity, avail herself or himself of the *de minimis* exceptions even though his or her contributions are otherwise considered contributions of the adviser itself).

225 Accordingly, a covered person of an investment adviser could, without triggering the prohibitions of the rule, contribute up to the limit in both the primary election campaign and the general election campaign of each official for whom the person making the contribution would be entitled to vote. The MSRB takes the same approach of excepting from rule G-37's time out trigger contributions up to the rule's *de minimis* amount for *each* election (including a primary and general election). *See* MSRB Rule G-37 Q&A, Question II.8. *See also In the Matter of Pryor, McClendon, Counts & Co., Inc., et al.*, Exchange Act Release No. 48095 (June 26, 2003) (noting that contributions must be limited to MSRB rule G-37's *de minimis* amount *before* the primary, with the same *de minimis* amount allowed *after* the primary for the general election).

226 *See* Proposing Release, at section II.A.3(a)(6).

227 *See* MSRB rule G-37(b)(i).

contribution as large as $1,000 would be unlikely to influence the award of an advisory contract by a public pension plan.[228]

The $1,000 amount suggested by some commenters strikes us as a rather large contribution that could influence the hiring decisions, depending upon the size of the jurisdiction, the amount of campaign contributions to opposing candidates, and the competitiveness of the primary or prospective election. Instead, we are taking the suggestion of several commenters[229] that we should increase the *de minimis* amount to reflect the effects of inflation since the MSRB first established its $250 *de minimis* amount in 1994.[230] We may consider increasing the $350 amount in the future if, for example, the value of it decreases materially as a result of further inflation.

Commenters also urged us to eliminate the condition that a covered associate must be able to vote for the candidate.[231] They asserted that persons can have a legitimate interest in contributing to campaigns of people for whom they are unable to

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228 *See, e.g.*, SIFMA Letter; NASP Letter; Comment Letter of Philip K. Holl (Oct.5, 2009) ("Holl Letter"); NSCP Letter; Caplin & Drysdale Letter; Cornell Law Letter; ICI Letter; MFA Letter; Seward & Kissel Letter; Callcott Letter II; Comment Letter of the California State Teachers' Retirement System (Oct. 6, 2009) (adopted policies that limit contributions to board members by those seeking investment relationships with the fund to $1,000). Several commenters suggested our proposed *de minimis* limit could be subject to a challenge on constitutional grounds. For a discussion of, and response to, these comments, see *supra* note 72 and accompanying text.

229 *See, e.g.*, Caplin & Drysdale Letter (recommending that we index the *de minimis* threshold for inflation); Cornell Law Letter (recommending that we index the *de minimis* threshold for inflation). *See also* Callcott Letter I.

230 We multiplied the $250 *de minimis* amount that we proposed (which was adopted by the MSRB in 1994) by the annual consumer price index (a measure of inflation) change since 1994, as reported by the Bureau of Labor Statistics (*available at* http://www.bls.gov/data/). The result was approximately $365 in 2009; we rounded it down to $350 for administrative convenience.

231 *See, e.g.*, T. Rowe Price Letter; Dechert Letter; MFA Letter; NASP Letter; Callcott Letter I; Cornell Law Letter; IAA Letter.

vote.[232] We acknowledge that persons can have such an interest, such as in large metropolitan areas where a covered associate may work and live in different jurisdictions. But commenters did not confine their recommendations to such circumstances and we remain concerned that contributions by executives of advisers living in distant jurisdictions may be less likely to be made for purely civic purposes. Accordingly, we have added a *de minimis* exception for contributions of up to $150 to officials for whom a covered associate is not entitled to vote, which is lower than the *de minimis* exception of $350 for candidates for whom a covered associate is entitled to vote. We believe that $150 is a reasonable amount for the additional *de minimis* exception we are adopting because of the more remote interest a covered associate is likely to have in contributing to a person for whom he or she is not entitled to vote.

(7) Exception for Certain Returned Contributions

We are adopting, largely as proposed, an exception that will provide an adviser with a limited ability to cure the consequences of an inadvertent political contribution to an official for whom the covered associate making it is *not* entitled to vote.[233] The exception is available for contributions that, in the aggregate, do not exceed $350 to any one official, per election.[234] The adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution[235] and,

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232 *See, e.g.*, T. Rowe Price Letter; Dechert Letter; MFA Letter; NASP Letter; Callcott Letter I; Cornell Law Letter.

233 Rule 206(4)-5(b)(3).

234 Rule 206(4)-5(b)(3)(i). We note that a contribution would not trigger the two-year ban at all to the extent it falls within the *de minimis* exception described in rule 206(4)-5(b)(1). *See* section II.B.2(a)(6) of this Release for a discussion of this exception.

235 *Id.*

within 60 days after learning of the triggering contribution, the contributor must obtain the return of the contribution.[236]

The scope of this exception is limited to the types of contributions that we believe are less likely to raise pay to play concerns. The prompt return of the contribution provides an indication that the contribution would not affect an official of a government entity's decision to award an advisory contract.[237] The relatively small amount of the contribution, in conjunction with the other conditions of the exception, suggests that it was unlikely to be made for the purpose of influencing the award of an advisory contract. Repeated triggering contributions suggest otherwise or that the adviser has not implemented effective compliance controls. Therefore, the rule limits an adviser's reliance on the exception to no more than two or three per 12-month period (based on the size of the adviser),[238] and no more than once for each covered associate,[239] regardless of the time period.[240]

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236 Rule 206(4)-5(b)(3)(i).

237 The 60-day limit is designed to give contributors sufficient time to seek its return, but still require that they do so in a timely manner. Also, this provision is consistent with MSRB rule G-37(j)(i). If the recipient will not return the contribution, the adviser would still have available the opportunity to apply for an exemption under paragraph (e) of the rule. Paragraph (e), which sets forth factors we would consider in determining whether to grant an exemption, includes as a factor whether the adviser has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution.

238 Rule 206(4)-5(b)(3)(ii). The approach we have taken will generally create some flexibility to accommodate a limited number of contributions by covered associates that would otherwise trigger the two-year time out. In a modification from our proposal that we believe is responsive to certain commenters' concerns (*see* note 251 and accompanying text below), "larger" advisers may avail themselves of three automatic exceptions, instead of two, in any calendar year. Rule 206(4)-5(b)(3)(ii). In contrast, our proposal would have permitted each adviser, regardless of its size, to rely on the automatic exception twice each year. The rule identifies a "larger" adviser for these purposes as any adviser who has reported in response to Item 5.A on its most recently filed Form ADV, Part 1A [17 CFR 279.1] that it has more than 50 employees. *Id.* Investment Adviser Registration Depository (IARD) data as of April 1, 2010 indicate that

Commenters who addressed it generally supported our inclusion of an automatic exception provision,[241] although several suggested modifications.[242] Some urged us to eliminate the requirement that the contributor succeed in obtaining the return of the contribution.[243] We are not making this change, which could undermine our goals in adopting the rule if it led to contributors asking for the return of a contribution where such requests were expected to be refused by the government official. We would have to discern whether the contributor itself, who may (or whose employer may) be seeking to influence government officials, has tried "hard enough" to get the contribution back.

Other commenters recommended an alternative exception for inadvertent contributions that would not require that an otherwise-triggering contribution be

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approximately 10 percent of registered advisers have more than 50 employees (and would therefore be limited to three "automatic" exceptions per calendar year instead of two). In particular, the data indicate that there are 11,607 registered investment advisers. Of those, 1,072 advisers (9.2% of the total) have indicated in their responses to Item 5.A of Part 1A of Form ADV that they have more than 50 employees. We chose the 50 employee cut-off because the number of employees is independently reported on Form ADV (and therefore cross-verifiable)—each adviser filing Form ADV must check a box indicating an approximation of the number of employees it has, choosing among 1-5, 6-10, 11-50, 51-250, 251-500, 501-1,000, or more than 1,000—and because we believe that inadvertent violations of the rule are more likely at advisers with greater numbers of employees. We think that the twice per year limit is appropriate for small advisers and the three times per year limit is appropriate for larger advisers. We do not believe it is appropriate for there to be greater variation in the number of times advisers may rely on the exception than that based either on their size or on other characteristics. We are seeking to encourage robust monitoring and compliance.

239 Rule 206(4)-5(b)(3)(iii). Once a covered associate has been made aware of an "inadvertent" violation, a justification for a second violation would be more questionable.

240 Although we have included different allowances for larger and smaller advisers (based on the number of employees they report on Form ADV), our approach otherwise generally tracks MSRB rule G-37's "automatic exemption" provision. *See* MSRB rule G-37(j).

241 *See, e.g.*, T. Rowe Price Letter; NSCP Letter; CT Treasurer Letter; Skadden Letter; ICI Letter; IAA Letter.

242 *See, e.g.*, NY City Bar Letter; Dechert Letter; IAA Letter.

243 *See, e.g.*, T. Rowe Price Letter; NSCP Letter; CT Treasurer Letter.

returned.[244] They contended that such an exception should be available to advisers with policies and procedures in place to prevent pay to play that include sanctions for employees violating the policies.[245] Such an approach excludes any objective indication that the contribution was inadvertent. As noted above, policies and procedures are required to ensure compliance with our rule. But policies and procedures alone, without critical objective criteria, such as obtaining a return of the contribution, are insufficient in our view to justify an exception to our prophylactic rule.

Some commenters urged us to modify or eliminate the requirement that the contribution be discovered by the adviser within four months.[246] We believe, however, that four months is the appropriate timeframe. We believe advisers should have a reasonable amount of time to discover contributions made by covered associates if, for example, their covered associates disclose their contributions to the adviser on a quarterly basis.[247] The absence of such a time limitation would encourage advisers not to seek to

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244 *See, e.g.*, IAA Letter (suggesting that we require, as a condition for such an exception, that "such contribution resulted in an inadvertent violation, meaning violations that are not reasonably known or condoned by the investment adviser and where the contributor lacked intent to influence the award of the advisory contract or violate the rule in making the contribution, as evidenced by the facts and circumstances surrounding such contribution").

245 *See, e,g.*, IAA Letter; Dechert Letter; NY City Bar Letter.

246 *See, e.g.*, T. Rowe Price Letter (arguing that, if an adviser has in place procedures to require covered associates to report all contributions no less frequently than quarterly, and an associate fails to report a contribution in violation of the procedures, the discovery of a prohibited contribution outside this four-month window should not preclude the use of this exception.). *But see* Fund Democracy/Consumer Federation Letter (urging us to consider shortening the time in which a contribution must be discovered for the exception to be available to one month).

247 Quarterly compliance reporting is familiar to advisory personnel. *See, e.g.*, rule 204A-1 under the Advisers Act (requiring that, under an adviser's code of ethics, personnel report personal securities trading activity at least quarterly). We do not believe the exception should be available where it takes longer for advisers to discover contributions made by covered associates because they might enjoy the benefits of a contribution's potential

discover such contributions if they believed they could simply rely on the exception any time a contribution happened to come to light.

A number of commenters suggested the exception be allowed for *all* contributions regardless of dollar amount, while a few recommended raising the dollar amount to $1,000.[248] As we noted above, we view the limitation on the amount of such a contribution, in conjunction with the other conditions of the exception, important to the rule because it is more likely that the contribution was, in fact, inadvertent. We have modified this "automatic" exception from our proposal by raising the limit on contributions eligible for the exception to $350, the same amount we have adopted as a *de minimis* threshold for contributions to an official for whom a covered associate is entitled to vote.[249] In addition, at the suggestion of commenters who argued that our proposed limitation on the annual use of such exception failed to take into consideration the different size of advisers,[250] we have modified our proposal to permit use of the exception three times in any year by an adviser that has reported on its Form ADV

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influence for too long a period of time. The condition that the contribution be discovered within four months is consistent with the MSRB's approach. *See* MSRB rule G-37(j)(i).

248 *See, e.g.*, SIFMA Letter; NASP Letter; Holl Letter; NSCP Letter; ICI Letter; MFA Letter.

249 Rule 206(4)-5(3)(i)(B). No automatic exception is available for any contributions to an official for whom the covered associate is entitled to vote that exceed the *de minimis* $350 amount. As explained above, we believe that $350 is the appropriate *de minimis* threshold for contributions to officials for whom a covered associate is entitled to vote and $150 is the appropriate *de minimis* threshold for contributions to officials for whom a covered associate it not entitled to vote. *See* section II.B(6) of this Release. Because these thresholds are different, we anticipate that covered associates could mistakenly make contributions up to the higher threshold under the mistaken belief that they are entitled to vote for an official when in fact they are not entitled to do so. So long as those contributions are returned and the other conditions of the exception are met, we believe they should be eligible for the automatic exception.

250 *See, e.g.*, Skadden Letter; T. Rowe Price Letter; NSCP Letter; ICI Letter; IAA Letter.

registration statement that it had more than 50 employees who perform investment advisory functions.[251]

The exception is intended to provide advisers with the ability to undo certain mistakes. Because it operates automatically,[252] we believe it should be subject to conditions that are objective and limited in order to capture only those contributions that are unlikely to raise pay to play concerns.[253]

(b) Ban on Using Third Parties to Solicit Government Business

Rule 206(4)-5 makes it unlawful for any investment adviser subject to the rule or any of the adviser's covered associates to provide or agree to provide, directly or indirectly, payment[254] to any person to solicit[255] government clients for investment

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251 *See supra* note 238.

252 The exception is "automatic" in the sense that an adviser relying on it may do so without notifying the Commission or its staff. However, we note that the recordkeeping obligations for registered advisers mandate specifically that an adviser maintain records regarding contributions with respect to which the adviser has invoked this exception. Rule 204-2(a)(18)(ii)(D). *See also* section II.D of this Release.

253 As discussed below in section II.B.2(f) of this Release, in other circumstances, advisers can apply to the Commission for an exemption from the rule's two-year time out. *See* rule 206(4)-5(e).

254 The term "payment" is defined in rule 206(4)-5(5)(f) as any gift, subscription, loan, advance, or deposit of money or anything of value. Depending on the specific facts and circumstances, payment can include *quid pro quo* arrangements whereby a non-affiliated person solicits advisory business for the adviser in exchange for being hired by the adviser to provide other unrelated services. This approach is consistent with the MSRB's with regard to MSRB rule G-38's third-party solicitor ban. *See* MSRB, *Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), *available at* http://msrb.org/msrb1/rules/notg38.htm. *But see infra* note 257 (discussing the provision of professional services by third parties).

255 For the definition of what it means to "solicit" a client or prospective client to provide investment advisory services, which we are adopting as proposed, see text accompanying note 185. This definition is consistent with the definition the MSRB employs for similar purposes in rule G-38, the MSRB's rule that restricts third-party solicitation activity. MSRB rule G-38(b)(i).

advisory services on its behalf.[256] The prohibition is limited to third-party solicitors. Thus, the prohibition does not apply to any of the adviser's employees, general partners, managing members, or executive officers.[257] Contributions by these persons, however, may trigger the two-year time out. As discussed in more detail below, the prohibition also does not apply to certain "regulated persons" that themselves are subject to prohibitions against engaging in pay to play practices.[258]

We proposed to prohibit advisers from paying third parties in order to prevent advisers from circumventing the rule.[259] We observed in the Proposing Release that solicitors or "placement agents" have played a central role in actions that we and other authorities have brought involving pay to play schemes;[260] in several instances, advisers allegedly made significant payments to placement agents and other intermediaries in order to influence the award of advisory contracts.[261] We noted that government authorities in New York and other jurisdictions have prohibited or are considering

256 Rule 206(4)-5(a)(2)(i). *See also* Proposing Release, at section II.A.3(b).

257 Rule 206(4)-5(a)(2)(i). We note that, so long as non-affiliated persons providing legal, accounting, or other professional services in connection with specific investment advisory business are not being paid directly or indirectly by an investment adviser for communicating with a government entity (or its representatives) for the purpose of obtaining or retaining investment advisory business for the adviser—*i.e.*, they are paid solely for their provision of legal, accounting, or other professional services with respect to the business—they would not become subject to the ban on payments by advisers to third-party solicitors. This approach is similar to the MSRB's with regard to MSRB rule G-38's third-party solicitor ban. *See* MSRB, *Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), *available at* http://msrb.org/msrb1/rules/notg38.htm.

258 This exception, which is responsive to commenters' concerns, is a modification of our proposal. As discussed below, we also eliminated an exception in our proposal that would have applied to "related persons" of the adviser and, if such "related person" were a company, an employee of the "related person." *See* Proposing Release, at section II.A.3(b).

259 *See* Proposing Release, at section II.A.3(b).

260 *Id.* at sections I and II.A.3(b).

261 *Id.* at section II.A.3(b).

limiting or prohibiting the use of consultants, solicitors, or placement agents by investment advisers to solicit government business.[262] We considered the MSRB's experience with solicitors, which ultimately led it to ban municipal securities dealers from hiring consultants to solicit government clients after concluding that less restrictive approaches were ineffective to prevent circumvention of MSRB rule G-37.[263] We recalled comment letters we received in 1999 from advisers asserting that they should not

[262] *Id.* Since our proposal, a few state and local governments have undertaken actions to prohibit or regulate pay to play practices involving placement agents in response to concerns about to pay to play activities in their jurisdictions. For example, New York City Comptroller John C. Liu announced reforms relating to how the New York City pension funds make investments (including prohibitions on gifts and campaign contributions, strict rules on employees of the Office of New York City Comptroller, employees and trustees of the New York City pension systems, fund managers, and placement agents, and an expansion of the ban on private equity placement agents to include placement agents to other types of funds while providing an exclusion for legitimate placement agents who provide value-added services). *See* Office of the New York City Comptroller, *Comptroller Liu Announces Major Reforms to Pension Fund Investments*, Press Release, Feb. 18, 2010, *available at* http://www.comptroller.nyc.gov/press/2010_releases/pr10-02-022.shtm. A bill was introduced in California that would treat placement agents soliciting government entity clients as lobbyists and therefore restrict them from charging contingency fees. *See* Assem. B. 1743, 2009-10 Leg., Reg. Sess. (Cal. 2010), *available at* http://info.sen.ca.gov/pub/09-10/bill/asm/ab_1701-1750/ab_1743_bill_20100208_introduced.html. *See also* Cal. Gov't. Code §86205(f) (Deering 2010). Another law was passed in California on an emergency basis imposing new disclosure obligations and prohibitions regarding placement agents. *See* Assem. B. 1854, 2009-10 Leg., Reg. Sess. (Cal. 2010) *available at* http://info.sen.ca.gov/pub/09-10/statute/ch_0301-0350/ch_301_st_2009_ab_1584. *See also* CalPERS, *CalPERS Releases Placement Agent Disclosures*, Press Release, Jan. 14, 2010, *available at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2010/jan/agent-disclosures.xml. (discussing recent actions by CalPERS to make public more than 600 placement agent disclosures from the fund's external managers).

[263] *See* Proposing Release, at n.130 and accompanying text. *See also* MSRB Letter ("Due to concerns regarding questionable practices by some consultants and a determination by the MSRB that it would be in the public interest to make the process of soliciting municipal securities business fully subject to the MSRB rules of fair practice and professionalism, the MSRB rescinded its original rule in 2005 and adopted new Rule G-38, on solicitation of municipal securities business, to prohibit dealers from using paid third-party consultants to obtain municipal securities business on their behalf.").

be held accountable for the political contributions of their third-party solicitors whom, they asserted, advisers lacked the ability to control.[264]

The record before us raised deeply troubling concerns about advisers' use of third-party solicitors to engage in pay to play activities.[265] We were concerned that a rule that failed to address the use of these solicitors would be ineffective were advisers simply to begin using solicitors and placement agents that have made political contributions or payments funded in part or in whole by the fees they receive from advisers.[266] Therefore, we proposed to prohibit advisers from engaging third parties to solicit government clients on their behalf.[267] In doing so, we requested comments on alternative approaches we

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264 In 1999, the Commission proposed a similar rule, which also would have been codified as rule 206(4)-5 under the Advisers Act, had it been adopted. *See Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999) [64 FR 43556 (Aug. 10, 1999)] ("1999 Proposing Release"). Comments on that proposal received electronically (comment file S7-19-99) are *available at* http://www.sec.gov/rules/proposed/s71999.shtml. Among the commenters on the 1999 Proposing Release who argued that advisers should not be held accountable for the political contributions of their third-party solicitors are: Comment Letter of Davis Polk (Nov. 1, 1999); Comment Letter of Legg Mason (Nov. 1, 1999); Comment Letter of MSDW (Nov. 1, 1999). At least one commenter on our 2009 proposal, although opposing the proposed third-party solicitor ban, took the same view. *See* MFA Letter ("We strongly agree with the SEC's comment in the Release that "covered associates" should not include employees of entities unaffiliated with an investment adviser, such as the employees of a third-party placement agent. An investment adviser would not have the authority or capability to monitor and restrict political contributions made by individuals not employed by the adviser.").

265 *See* Proposing Release, at section I; section I of this Release. Moreover, "no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic." *Blount*, 61 F.3d at 945.

266 *See* Proposing Release, at section II.A.3(b). Some commenters have supported this approach. *See, e.g.*, Fund Democracy/Consumer Federation Letter ("Permitting advisers to circumvent pay-to-play restrictions by hiring solicitors would eviscerate the heart of the direct prohibition against advisers' bribing politicians in return for money management contracts."). We also noted commenters' concerns regarding the difficulties advisers face in monitoring the activities of their third-party solicitors. *See* Proposing Release, at section II.A.3(b).

267 *See* Proposing Release, at section II.A.3(b).

could take.[268] We wanted to know whether there might be a more effective means to accomplish our objectives, or means that would be less restrictive.

We received a large number of comments on this question. We received letters from the New York State Comptroller and New York City Comptroller that expressed strong support for the ban on using third parties to solicit government plans.[269] One commenter supporting the ban pointed out the key role that placement agents have played in pay to play practices.[270] It expressed concern that adopting the rule without the ban would exacerbate the problem by placing more pressure on advisers to pay "well-connected" placement agents for access since the advisers will be limited in their contributions.[271] Another commenter expressed the view that "the most egregious violations of the public trust in this area have come from placement agents and those seeking finder's fees. The outright ban on their use to deter pay-to-play schemes is entirely appropriate."[272]

Most commenters, including many representing advisers, broker-dealers, placement agents and solicitors, and some government officials, however, strongly opposed the ban. Many asserted that solicitors, consultants and placement agents provide valuable services both for advisers seeking clients and for the public pension plans that

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268 *See id.*

269 DiNapoli Letter; Thompson Letter (as indicated in note 262 above, NYC Comptroller Liu recently announced his office's approach to third-party solicitors).

270 Fund Democracy/Consumer Federation Letter.

271 *Id.*

272 Common Cause Letter. *See also* Cornell Law Letter (generally supporting the prohibition on using third-party solicitors "given that third-party solicitors have played a central role in each of the enforcement actions against investment advisors that the Commission has brought in the past several years involving pay-to-play schemes.").

employ them and that banning their use would have several deleterious effects.[273] Several claimed that the rule would favor banks because banks are excluded from the definition of "investment adviser" under the Advisers Act and therefore are not subject to the Commission's rules, including rule 206(4)-5.[274] Others claimed the rule would favor larger investment advisers (which have internal marketing departments) over smaller firms.[275] Other commenters asserted the ban would harm smaller pension funds that do

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273 *See, e.g.*, Comment Letter of Senator Christopher J. Dodd (Feb. 2, 2010) ("Dodd Letter"); NY City Bar Letter; Dechert Letter; ABA Letter; Comment Letter of Teacher Retirement System of Texas (Oct. 12, 2009); Comment Letter of Bryant Law (Oct. 9, 2009) ("Bryant Law Letter"); Comment Letter of Probitas Partners (Oct. 6, 2009) ("Probitas Letter"); Comment Letter of Larry Simon (Oct. 6, 2009) ("Simon Letter"); Comment Letter of MarketCounsel, LLC (Oct. 6, 2009); ICI Letter; Comment Letter of Colorado Public Employees' Retirement Association (Oct. 6, 2009); Skadden Letter.

274 *See* Advisers Act section 202(a)(11)(A) [15 U.S.C. 80b-2(a)(11)(A)] (excepting from the definition of "investment adviser," and therefore from regulation under the Advisers Act, "a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company . . . ."). We discuss possible competitive effects of our rule's inapplicability to banks in section VI of this Release. We believe that the concerns the rule is designed to address, as discussed throughout this Release, warrant its adoption, notwithstanding these potential competitive effects.

275 *See, e.g.,* SIFMA Letter; IAA Letter; MFA Letter; Comment Letter of National Conference on Public Employee Retirement Systems (Oct. 6, 2009) ("NCPERS Letter"); Comment Letter of European Private Equity & Venture Capital Association (Sept. 9, 2009) ("EVCA Letter"); Seward & Kissel Letter; Comment Letter of Sadis & Goldberg LLP (Oct. 2, 2009) ("Sadis & Goldberg Letter"); Comment Letter of State of Wisconsin Investment Board (Aug. 31, 2009) ("WI Board Letter"); Comment Letter of the Executive Director of Georgia Firefighters' Pension Fund, James R. Meynard, (Sept. 3, 2009) ("GA Firefighters Letter"); Comment Letter of Minnesota State Board of Investment (Sept. 8, 2009) ("MN Board Letter"); Comment Letter of Illinois Public Pension Fund Association (Sept. 29, 2009) ("IL Fund Association Letter"); Comment Letter of Melvyn Aaronson, Sandra March and Mona Romain, Trustees of the Teachers' Retirement System of the City of New York (Oct. 1, 2009) ("NYC Teachers Letter"); Comment Letter of the Texas Association of Public Employee Retirement Systems (Oct. 6, 2009) ("TX Public Retirement Letter"); Comment Letter of the Pennsylvania Public School Employees' Retirement Board (Oct. 6, 2009) ("PA Public School Retirement Letter"); Comment Letter of the California State Association of County Retirement Systems (Sept. 8, 2009) ("CA Assoc. of County Retirement Letter"); Caplin & Drysdale Letter; Comment Letter of Paul Ehrmann (Aug. 10, 2009) ("Ehrmann Letter"); Comment Letter of Joseph Finn (Aug. 10, 2009) ("Finn Letter"); Comment Letter of the Managing Partner of The Savanna Real Estate Fund I, LLP, Nicholas Bienstock (Aug. 11, 2009) ("Savanna Letter"); Comment Letter of Atlantic-Pacific Capital, Inc. (Aug. 12, 2009) ("Atlantic-Pacific Letter"); Comment Letter of Tricia Peterson (Aug. 14, 2009)

not have the resources to conduct a search for advisers on their own, and harm advisers that rely on the services that placement agents provide.[276] A number of commenters argued that the prohibition would reduce competition by reducing the number of advisers competing for government business,[277] and limit the universe of investment opportunities presented to public pension funds.[278]

Many of these commenters conceded that there is a problem with placement agents and other intermediaries, but asserted it is caused by a few bad actors, for which an entire industry should not be penalized.[279] A common theme among many

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("Peterson Letter"); Comment Letter of Devon Self Storage Holdings (US) LLC (Aug. 21, 2009) ("Devon Letter"); Comment Letter of Thomas Capital Group, Inc. (Aug. 24, 2009) ("Thomas Letter"); Comment Letter of Stephen R. Myers (Aug. 26, 2009) ("Myers Letter"); Comment Letter of Chaldon Associates LLC (Aug. 26, 2009) ("Chaldon Letter"); Comment Letter of The Meridian Group (Aug. 26, 2009) ("Meridian Letter"); Comment Letter of Benedetto, Gartland & Company, Inc. (Sept. 30, 2009) ("Benedetto Letter"); Comment Letter of the Partners of CSP Securities, LP and Capstone Partners, LP (Sept. 17, 2009) ("Capstone Letter"); Comment Letter of Presidio Partners LLC Managing Partner Alan R. Braxton (Sept. 21, 2009) ("Braxton Letter"); Comment Letter of Littlejohn & Co., LLC (Sept. 14, 2009) ("Littlejohn Letter"); Comment Letter of Alta Communications (Sept. 18, 2009) ("Alta Letter"); Comment Letter of Charles River Realty Investors LLC (Sept. 23, 2009) ("Charles River Letter"); Comment Letter of W. Allen Reed (Sept. 19, 2009) ("Reed Letter"); Comment Letter of Glovista Investments LLC (Sept. 23, 2009) ("Glovista Letter"); Comment Letter of The Blackstone Group (Sept. 14, 2009) ("Blackstone Letter"); Park Hill Letter. Two commenters noted that the ban would result in less transparency as these services go "in-house." CalPERS Letter; Bryant Law Letter. Others commented on the effects on minority and women-owned firms. *See, e.g.*, NYC Teachers Letter, Myers Letter; GA Firefighters Letter; MN Board Letter; Blackstone Letter.

276 *See, e.g.*, Dodd Letter; NY City Bar Letter; Dechert Letter; ABA Letter; Probitas Letter; Seward & Kissel Letter; MFA Letter.

277 *See, e.g.*, Seward & Kissel Letter; Meridian Letter; NY City Bar Letter; Probitas Letter; Simon Letter; MFA Letter.

278 *See, e.g.*, SIFMA Letter; IAA Letter; Strategic Capital Letter; Alta Letter; Benedetto Letter; Comment Letter of Jim Glantz (Sept. 24, 2009) ("Glantz Letter"); Comment Letter of Venera Kurmanaliyeva (Sept. 15, 2009) ("Kurmanaliyeva Letter"); Park Hill Letter.

279 *See, e.g.*, Comment Letters of Brady Pyeatt (Aug. 4, 2009) & (Oct. 6, 2009); Comment Letter of Andrew Wang (Aug. 10, 2009); Comment Letter of Monomoy Capital Management, LLC (Aug. 25, 2009) ("Monomoy Letter"); Comment Letter of Ted Carroll

commenters was that the rule failed to distinguish "illegitimate" consultants and placement agents from the "legitimate" ones who provide an important service.[280]

We believe that many of the comments overstate the likely consequences of adoption of the rule. First, the rule will not prevent public pension plans from hiring their own consultants—*i.e.*, using their own resources—to assist them in their search for an investment adviser.[281] These consultants would have access to information about smaller advisers whose services may be appropriate for the plan. Many public pension plans already make—or are required to make—specific accommodations for so-called "emerging money managers" that otherwise may have difficulty getting noticed by public pension plans.[282] Second, these commenters failed to consider the potentially significant

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(Aug. 4, 2009); Comment Letter of James C. George (Sept. 10, 2009) ("George Letter"); Comment Letter of Ariane Capital Partners LLC (Sept. 17, 2009); Blackstone Letter; Comment Letter of Nancy Fossland (Sept. 16, 2009); Comment Letter of Steven A. Friedmann (Sept. 14, 2009); Comment Letter of Keith P. Harney (Sept. 15, 2009); Comment Letter of Robert F. Muhlhauser III (Sept. 14, 2009); Comment Letter of XT Capital Partners, LLC (Sept. 30, 2009); CapLink Letter.

280 *See, e.g.*, Bryant Law Letter; Comment Letter of Hedgeforce (Oct. 6, 2009) ("Hedgeforce Letter").

281 *See* Fund Democracy/Consumer Federation Letter ("The proposed ban would "deny access" to nothing. There is nothing [in the proposed rule] preventing pension funds from retaining their own consultants whose sole responsibility is to the pension fund and its beneficiaries.").

282 *See, e.g.*, Randy Diamond, *CalPERS CIO Joe Dear says Emerging Managers Don't Need Placement Agents*, PENSIONS & INVESTMENTS, Feb. 24, 2010, *available at* http://www.pionline.com/article/20100224/REG/100229965; Michael Marois, *CalPERS, Blackstone Clash over Placement Agent 'Jackpot' Fees*, BLOOMBERG (Apr. 7, 2010), available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acPNrTn1q7pw (quoting CalPERS CIO Joe Dear, "There's clear evidence in past practice that it's possible to develop an investment relationship with us by making a normal approach, without the assistance of a contingent-paid placement agent."); Ohio Pub. Employees Ret. Sys., *Ohio-Qualified and Minority Manager Policy* (May 2006), *available at* https://www.opers.org/pdf/investments/policies/Ohio-Qualified-Minority-Manager-Policy.pdf; Teachers' Ret. Sys. of the State of Ill., Fiscal Year 2009 Annual Report on the use of Women, Minority and Disabled-Owned (W/MBE) Investment Advisors and Broker/Dealers (Aug. 31, 2009), *available at*

costs of hiring consultants and placement agents,[283] which already may make them unavailable to smaller advisers. Eliminating the cost of pay to play may, in fact, provide greater access to pension plans by those advisers which are unable to afford the costs of direct or indirect political contributions or placement agent fees.[284] We expect that prohibiting pay to play may reduce the costs to plans and their beneficiaries of inferior asset management services arising from adviser selection based on political contributions rather than investment considerations.[285] Finally, commenters failed to identify any

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http://trs.illinois.gov/subsections/investments/minorityrpt.pdf; Md. State Ret. and Pension Sys., *Terra Maria: The Maryland Developing Manager Program*, *available at* http://www.sra.state.md.us/Agency/Investment/Downloads/TerraMariaDevelopingManagerProgram-Description.pdf; Thurman V. White, Jr., Progress Inv. Mgmt. Co., *Successful Emerging Manager Strategies for the 21st Century*, 3 (2008), *available at* http://www.progressinvestment.com/content/files/successful_emerging_manager_strategies.pdf (containing a "representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies").

283 One commenter made a similar point: "The proposed ban would simply replace the indirect cost of placement agents incurred by pension plan sponsors with the direct cost of hiring their own placement agents—without the conflict of interest and potential for abuse that relying on advisers' placement agents creates. It is not the cost of independent advice that the Commission has not accounted for in its proposal, but the cost of conflicts that critics have failed to acknowledge in their analysis." Fund Democracy/Consumer Federation Letter.

284 At least one commenter agreed. *See* Butler Letter ("[W]e find some evidence that the pay to play practices by underwriters [before rule G-37 was adopted] distorted not only the fees, but which firms were allocated business. The current proposal mentions that pay to play practices may create an uneven playing field among investment advisers by hurting smaller advisers that cannot afford to make political contributions. We find evidence that is consistent with this view [in our research on pay to play by municipal underwriters]. During the pay to play era, municipal bonds were underwritten by investment banks with larger underwriting market shares compared to afterward. One interpretation of this result is that smaller underwriters were passed over in favor of larger underwriters (who presumably had deeper pockets for political contributions)."). As we indicated in the Proposing Release, pay to play practices may hurt smaller advisers that cannot afford the required contributions. Curtailing pay to play arrangements enables advisory firms, particularly smaller advisory firms, to compete on merit, rather than their ability or willingness to make contributions. *See* Proposing Release, at sections I and IV.

285 *See* Tobe Letter (describing an under-performing money manager that was fired after the commenter, a pension official, began to inquire into how it was selected); Weber Letter ("I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the

meaningful way in which our rule might distinguish "legitimate" from "illegitimate" solicitors or placement agents. Even solicitors and placement agents that engage in pay to play may appear to operate "legitimately."[286]

Some commenters suggested alternatives to our proposed ban to address our concern that pay to play activities are often carried out through or with the assistance of third parties.[287] Several commenters, for example, suggested that we instead require greater disclosure by advisers of payments to solicitors.[288] Such an approach could be

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fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen.").

286 *See Blount*, 61 F.3d at 944 ("actors in this field are presumably shrewd enough to structure their relations rather indirectly").

287 We note that, in addition to the alternatives discussed below, some commenters called for approaches outside the scope of our authority, such as an outright ban on all political contributions by third-party solicitors, the imposition of criminal penalties, or modification of the structure of pension boards. *See, e.g.*, Monomoy Letter (arguing that the Commission or the appropriate criminal authority should mandate jail time for public officials and intermediaries where the official gets a benefit from a public fund investment in a particular fund, that all managers of intermediaries who receive fees in such transactions should be banned from the financial services industry for life, and that all members of the general partner (manager) of the fund in which the investment is made be banned from the financial services industry for life); NCPERS Letter (arguing that the most effective method of eliminating pay to play is by having multiple trustees on public pension boards); Thomas Letter (suggesting that stronger internal control procedures, segregation of duties and dispersed or committee approval of granting pension business could help prevent pay to play activities, each of which historically has involved a complicit senior public plan fund official); Comment Letter of the Massachusetts Pension Reserves Investment Management Board (Aug. 26, 2009) ("PRIM Board Letter"); Preqin Letter I (acknowledging that it is outside the remit of the Commission, but arguing that there should be better oversight of public pension funds, and investment committees should consist of a minimum number of members in order to prevent a sole official being responsible for the investment-decision process); Triton Pacific Letter (arguing that the Commission should adopt regulation of pension officials who are often responsible for initiating pay to play arrangements).

288 Several commenters urged us to require advisers to disclose to clients their payments to third-party solicitors and placement agents. *See, e.g.*, ABA Letter; 3PM Letter; ICI Letter; NY City Bar Letter; Comment Letter of Forum Capital Securities, LLC (Oct. 5, 2009) ("Forum Letter"); Jones Day Letter; CapLink Letter. Some asserted that existing disclosure requirements, such as those included in the Commission's investment adviser cash solicitation rule, are sufficient to address pay to play. *See, e.g.*, Comment Letter of

helpful to give plan fiduciaries information necessary for them to satisfy their legal obligations and uncover abuses,[289] but it would not be useful when plan fiduciaries themselves are participants in the pay to play activities.[290] In addition, as one commenter pointed out, the MSRB had already sought unsuccessfully to address the problem of placement agents and consultants engaging in pay to play activities on their principals' behalf through mandating greater disclosure.[291]

Steven Rubenstein (Aug. 17, 2009) ("Rubenstein Letter") (noting that Advisers Act rule 206(4)-3 [17 CFR 275.206(4)-3], the "cash solicitation rule," is adequate as is, but "just needs to be followed"); Thomas Letter (supporting "enforcement of existing disclosure rules"); Chaldon Letter (arguing that, in the scandals that have recently occurred, if the fee sharing arrangements had been disclosed to pension fund boards, no law or regulation would have been violated, and that third-party marketers should adhere to current law instead of banning a legitimate business practice); Comment Letter of Ray Wirta (Sept. 4, 2009) (arguing that all that is necessary is that penalties should be heightened, enforcement stepped up and results highly publicized); Arrow Letter (arguing that enforcement of the Advisers Act and FINRA requirements have ensured lawful and ethical business practices for decades); 3PM Letter (arguing that the rule's scope could be extended to include various additional disclosures). But we do not believe, for the reasons described above, that enforcement of existing obligations alone is sufficient to deter pay to play activities.

289 Some public pension plans have adopted policies requiring advisers they hire to disclose information about placement agents, including their political connections. *See, e.g.*, Cal. Pub. Employees Ret. Sys., *CalPERS Adopts Placement Agent Policy – Requires Disclosure of Agents, Fees,* Press Release (May 11, 2009), *available at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2009/may/adopts-placement-agent-policy.xml.

290 For examples of cases in which plan fiduciaries themselves have allegedly participated in pay to play activities involving placement agents, see *New York v. Henry "Hank" Morris and David Loglisci*, Indictment No. 25/2009 (NY Mar. 19, 2009) (a public official was alleged to be a beneficiary of the pay to play activities); *SEC v. Paul J. Silvester, et al.*, Litigation Release No. 16759, Civil Action No. 3:00-CV-19411 DJS (D. Conn. 2000) (former Connecticut State Treasurer was alleged to be a beneficiary of a pay to play scheme in which an investment adviser to a private equity fund had paid third-party solicitors to obtain public pension fund investments in the fund). *See also* Proposing Release, at n.49 (discussing additional reasons why we believe a disclosure approach would not effectively address our concerns regarding pay to play activities).

291 Cornell Law Letter ("For example, after concluding that required disclosure was neither adequate to prevent circumvention nor consistently being made, the [MSRB] amended its own rules on pay-to-play practices in the municipal securities markets to impose a complete ban on the use of third-party consultants to solicit government clients." (citations omitted)). *See also* 3PM Letter (acknowledging that, although increased

Other commenters recommended that we rely on voluntary industry codes of conduct.[292] But we believe, in light of the growing body of evidence of advisers' use of third-party solicitors to engage in pay to play activities we describe above, that voluntary actions are insufficient to deter pay to play, which may yield lucrative management contracts.[293] As we discuss above, pay to play involves a "collective action" problem that is unlikely to be resolved by voluntary actions.[294] Elected officials who accept contributions from state contractors may believe they have an advantage over their opponents who foreswear the contributions, and firms that do not "pay" may fear that they will lose government business to those that do.[295]

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transparency by all parties involved in the investment process who might have the ability to exert influence, including advisers, third-party marketers, public officials or other trustees, etc., is necessary to minimize the adverse effects of pay to play, the issue will not be completely solved by disclosure).

292 *See, e.g.*, MVision Letter (arguing that self-regulatory initiatives such as the EVCA's Code of Conduct for Placement Agents are working and that many public pension plans' own anti-pay to play policies have been successful); EVCA Letter (describing its Code of Conduct that prohibits pay to play and is supported by various stakeholders and arguing that it, along with strong punishment of wrongdoers, should restore confidence in the process). Another commenter suggested a code of conduct enforceable by regulators. Comment Letter of Charlie Eaton on behalf of a Coalition of Professional Institutional Placement Agents (Sept. 9, 2009) (proposing an industry Code of Conduct that could be enforced by FINRA and the Commission, which should ban firms that do not adhere from doing business with all potential investors, public and private). In our view, the rule we are adopting today not only essentially serves this purpose, but more appropriately reflects prohibitions we, instead of others, have determined appropriately address our concerns.

293 *See* Proposing Release, at sections I and II.A.3(b). *See also* section I of this Release.

294 *See supra* note 58 and accompanying text.

295 *See Blount*, 61 F.3d at 945-46 (describing the parallel dynamics applicable in municipal underwriting, "As beneficiaries of the practice, politicians vying for state or local office may be reluctant to stop it legislatively; some, of course, may seek to exploit their rivals' cozy relation with bond dealers as a campaign issue, but if they refuse to enter into similar relations, their campaigns will be financially handicapped. Bond dealers are in a still worse position to initiate reform: individual firms that decline to pay will have less chance to play, and may even be the object of explicit boycott if they do.").

Other commenters recommended that we amend our rules to require that advisers amend their codes of ethics to monitor contributions by third-party solicitors.[296] But advisers using third-party solicitors to circumvent pay to play restrictions are well aware of these payments, and are unlikely to be deterred by a monitoring requirement. In addition, adviser codes of ethics are unlikely to be a sufficient means to induce third-party solicitors to be transparent about their own pay to play activities.

Instead of suggesting alternative approaches, other commenters urged us to apply the rule more narrowly by exempting from the ban solicitors that are registered broker-dealers or associated persons of broker-dealers.[297] Some were concerned that the rule would interfere with traditional distribution arrangements of mutual funds and private funds, which are usually distributed by registered broker-dealers that may be compensated by the adviser in some form.[298] Many argued that registration as a broker-dealer generally differentiates placement agents that provide "legitimate" services from

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296 *See, e.g.*, ABA Letter; 3PM Letter; ICI Letter; NY City Bar Letter; Forum Letter; Jones Day Letter.

297 *See, e.g.*, Davis Polk Letter; Comment Letter of UBS Securities LLC (Oct. 2, 2009) ("UBS Letter").

298 *See, e.g.*, SIFMA Letter; NY City Bar Letter; Monomoy Letter; IAA Letter. Mutual fund distribution fees are typically paid by the fund pursuant to a 12b-1 plan, and therefore generally would not constitute payment by the fund's adviser. As a result, such payments would not be prohibited by rule 206(4)-5 by its terms. Where an adviser pays for the fund's distribution out of its "legitimate profits," however, the rule would generally be implicated. For a discussion of a mutual fund adviser's ability to use "legitimate profits" for fund distribution, see *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)] (explaining, in the context of the prohibition on the indirect use of fund assets for distribution, unless pursuant to a 12b-1 plan, "[h]owever, under the rule there is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources . . . . Profits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the [Investment Company] Act."). For private funds, third parties are often compensated by the adviser or its affiliated general partner and, therefore, those payments are subject to the rule. Structuring such a payment to come from the private fund for the purpose of evading the rule would violate the rule. *See* Rule 206(4)-5(d).

those that merely offer political influence.[299] Others expressed concern that some broker-dealer firms that rely on placement agent business could be harmed.[300] We recognize that services that commenters have identified as beneficial would typically require broker-dealer registration. But registration under the Exchange Act does not preclude a broker-dealer from participating in pay to play practices—MSRB rules G-37 and G-38 do not apply, for example, to broker-dealers soliciting investments on behalf of investment companies or private funds.[301] Thus, amending our rule to limit third parties soliciting governments to broker-dealers registered under the Exchange Act would not achieve the prophylactic purpose of this rulemaking. We believe that our approach is appropriate in light of the concerns we are seeking to address.[302]

Several commenters proposed that we achieve our goals by permitting advisers to engage solicitors and placement agents that are registered broker-dealers and subject to rules similar to those adopted by the MSRB.[303] One asserted that such rules would be "a

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299 *See, e.g.*, Bryant Law Letter; Hedgeforce Letter; Comment Letter of Girard Miller (Aug. 8, 2009); Comment Letter of Frank Schmitz (Aug. 11, 2009) ("Schmitz Letter"); Atlantic-Pacific Letter; Rubenstein Letter; Thomas Letter; Monomoy Letter; MVision Letter; Comment Letter of Lime Rock Management (Sept. 28, 2009); Benedetto Letter; Strategic Capital Letter; Comment Letter of Portfolio Advisors, LLC (Oct. 2, 2009) ("Portfolio Advisors Letter"); UBS Letter; Comment Letter of Brian Fitzgibbon (Oct. 5, 2009); Comment Letter of GenNx360 Capital Partners, L.P. (Oct. 5, 2009).

300 Comment Letter of the National Association of Independent Broker-Dealers (Oct. 5, 2009).

301 At least one commenter suggested that there are "inherent" safeguards in the broker-dealer regulatory regime sufficient to protect against pay to play practices. *See, e.g.*, ABA Letter. But the broker-dealer regulatory regime does not specifically address pay to play activities, as demonstrated by the MSRB's adoption of rules G-37 and G-38.

302 We acknowledge that there are costs associated with our rule. For further analysis of these, along with the benefits, see sections I and IV of this Release.

303 Skadden Letter ("The Commission and FINRA could directly impose and enforce restrictions on such broker-dealers."); Davis Polk Letter ("Registered broker-dealers that provide legitimate placement agent services could be required by the Commission to comply with "pay-to-play" restrictions"); Credit Suisse Letter (preclude an investment

logical extension of the already-existing regulatory scheme governing broker-dealers."[304] Another agreed, arguing that such rules would be consistent with the approach the MSRB took when it adopted MSRB rule G-38, the effect of which was to sweep "all solicitors of municipal business (underwriting, sales and advisory) into the broker-dealer registration regime" where they would be subject to oversight of a registered broker-dealer and are required to conform their municipal securities activities to applicable MSRB rules, including MSRB rule G-37.[305] Others suggested we could similarly achieve our goals by

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adviser from using a placement agent that is not subject to pay to play restrictions analogous to rule G-37); Comment Letter of the President of M Advisory Group J. Daniel Vogelzang (Sept. 18, 2009) ("M Advisory Letter") (treat "[a]ll placement agents, investment advisers and consultants . . . exactly the same regarding prohibited political contributions; *i.e.*, a two-year ban on doing business with any governmental agency to which a prohibited political contribution is made."). *See also* Comment Letter of Hudson Capital Management (NY), L.P. (Oct. 5, 2009) (suggesting Commission take measures to properly license and regulate third-party solicitors); SIFMA Letter ("The pay-to-play and political activity of registered placement agents involved in soliciting government investment could . . . be directly regulated under the Exchange Act."). We believe our rule, as adopted, which allows advisers to pay certain regulated third parties to solicit government clients on their behalf, addresses these concerns. *See infra* notes 312-26 and accompanying text.

304 Davis Polk Letter.

305 SIFMA Letter ("Although Rule G-38(a) specifically prohibits a municipal dealer from paying a fee to a nonaffiliated person for solicitation of municipal securities business, the policies underlying Rule G-38 were to bring solicitors within the purview of the federal securities laws — not to exclude the involvement of registered broker-dealers, including those registered broker-dealers not affiliated with advisers and private funds."). *See also* Monument Group Letter ("We believe that MSRB Rule G-38 is not analogous to the proposed rule. Rule G-38 permits a broker-dealer that is unaffiliated with an issuer to market that issuer's securities to a public pension plan or any other investor. Proposed Rule 206(4)-5(a)(2)(i) prevents this and seeks to entirely disintermediate the process between the issuer of a security and the ultimate investor."); Credit Suisse Letter ("[W]e strongly believe that a more complete analogy to the MSRB Pay-to-Play Rules would not preclude regulated broker-dealers from performing placement agent services in the context of municipal investors, as the Proposed Rule would do. Notably, the MSRB Pay-to-Play Rules do not preclude SEC-registered broker-dealers from acting as placement agents to municipal issuers. Instead, the MSRB Pay-to-Play Rules subject such placement agents to "pay-to-play" restrictions and requirements and preclude them from retaining unregulated third-party finders and solicitors.").

permitting advisers to engage as solicitors registered investment advisers that are themselves subject to pay to play restrictions under an Advisers Act rule.[306]

We are persuaded by these comments and have decided to revise the proposed rule to permit advisers to make payments to certain "regulated persons" to solicit government clients on their behalf.[307] As described in more detail below, "regulated persons" include certain broker-dealers and registered investment advisers that are themselves subject to prohibitions against participating in pay to play practices and are subject to our oversight and, in the case of broker-dealers, the oversight of a registered national securities association, such as FINRA.[308] As one commenter observed, "the Commission would have the direct authority to determine these restrictions as well as the oversight, control and enforcement of penalties over any violations. The restrictions could be tailored to operate with the same underlying purpose and effect on [solicitors] as the "pay-to-play" restrictions imposed on investment advisers."[309] We believe that the application of such rules would provide an effective deterrent to these solicitors or placement agents from participating in pay to play arrangements because political contributions or payments would subject solicitors to similar consequences, as discussed

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306 *See, e.g.*, IAA Letter.

307 *See* Rule 206(4)-5(a)(2)(i).

308 Rule 206(4)-5(f)(9). *See supra* note 85 (noting that, in this Release, we will refer directly to FINRA, currently the only registered national securities association). As noted below, under the definition of "regulated persons" as it applies to brokers, the Commission must find, by order, that a registered national securities association's pay to play rule applicable to such brokers imposes substantially equivalent or more stringent restrictions on them than rule 206(4)-5 imposes on investment advisers and that such rule is consistent with the objectives of rule 206(4)-5. Rule 206(4)-5(f)(9)(ii)(B).

309 Davis Polk Letter.

below.[310] Because rule 206(4)-5 prohibits an adviser from compensating a registered adviser solicitor for solicitation activities if that adviser solicitor does not meet the definition of "regulated person," the adviser that hired the solicitor must immediately cease compensating a solicitor that no longer meets these conditions.[311]

In light of our decision to permit advisers to make payments to certain "regulated persons," described below, to solicit government clients on their behalf, we no longer believe that our proposed exception from the prohibition on advisers paying third-party solicitors for payments to related persons and employees of related person companies of the adviser is necessary.[312] We had proposed the exception to enable advisers to compensate these persons for government entity solicitation activities because we recognized there may be efficiencies in allowing advisers to rely on these particular types

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310 Another group of commenters argued that third-party solicitors should be treated as covered associates—that is, their contributions should trigger the two-year ban for advisers that hire them. *See, e.g.*, ABA Letter; 3PM Letter; ICI Letter; NY City Bar Letter; Forum Letter; Jones Day Letter. In explaining our rejection of this approach in the Proposing Release, we noted that this approach—which we included our 1999 pay to play proposal—was criticized by commenters at that time. *See* Proposing Release, at section II.A.3(b). They primarily argued that it was unfair to impute the activities of third parties to advisers, especially given what they perceived as the harsh consequences caused by a triggering contribution—*i.e.*, a two-year time out imposed on the adviser. *See id.* They further argued that an approach in which contributions by third-party solicitors triggered a two-year time out for an adviser would create over-burdensome compliance challenges because the adviser could not meaningfully control the contribution activities of such third parties. *See id.* We continue to be sympathetic to these concerns and believe that an approach in which a contribution by a third party triggered a two-year time out for the adviser that hires the third party as a solicitor could lead to unfair consequences. *See, e.g.*, Capstone Letter; Monument Group Letter; Park Hill Letter. For example, if a solicitor gives a triggering contribution in order to assist one client, we are concerned about the harsh result that such a contribution could have on all of the solicitor's other clients seeking business with the same prospective government entity client.

311 It would be a violation of the rule for an adviser to compensate a third party for solicitation of government entity clients at any time that third party did not meet the definition of "regulated person," regardless of whether the "regulated person" failed to meet the definition at the time it was hired or subsequently.

312 *See* Proposing Release, at section II.A.3(b).

of persons to assist them in seeking clients. We requested comment regarding whether the exception would undermine the rule's efficacy by allowing advisers to compensate certain employees of related person companies whose contributions would not have triggered the two-year time out. Although we did not receive comment specifically addressing our concern,[313] we believe the approach we are adopting that allows advisers to pay "regulated persons" to solicit government entities on their behalf will still allow advisers to use employees of certain related companies—*i.e.*, of those related companies that qualify as "regulated persons"—as solicitors.[314]

(1) Registered Broker-Dealers

Registered national securities association rules of similar scope and consequence as the rule we are today adopting could sufficiently satisfy the concerns that led us to propose to prohibit advisers from paying brokers to solicit potential government clients. Advisers could not easily use placement agents covered by such rules to circumvent rule 206(4)-5. Under this approach, placement agents would be deterred from engaging in pay to play directly on account of the registered national securities association's rules.

313 One commenter asked that we clarify the proposed exception for related parties (Sutherland Letter) and another recommended a case-by-case determination of whether independent contractors may be eligible for the exception, due to concern for life insurance agents who may not technically have qualified as "employees" for purposes of the exception (Skadden Letter). As noted, however, we have eliminated this exception in favor of allowing advisers to pay "regulated persons," affiliated or not, to solicit government clients on their behalf.

314 We acknowledge that some advisers may have to bear certain additional costs of hiring outside parties as a result of our elimination of our proposal's "related person" exception, which would have allowed advisers to compensate related persons that are not registered broker-dealers or advisers for solicitation activities. For a discussion of costs relating to the rule, see section IV of this Release. But, we also note that the rule, as adopted, does not favor an adviser with affiliates (which our proposal would have allowed an adviser to use to solicit on its behalf) over another adviser without affiliates. Instead, our rule, as adopted, allows an adviser to pay a "regulated person" affiliated or not, to solicit on its behalf.

There would be no need for the Commission to prove in an enforcement action that a contribution by a placement agent amounted to an indirect contribution by the investment adviser because the placement agent itself could be charged with violating the registered national securities association's rules. Therefore, as adopted, rule 206(4)-5 allows an adviser to compensate "regulated persons," which includes registered brokers subject to a registered national securities association's rules, for soliciting government clients on its behalf.[315] An adviser may engage a registered broker to solicit government clients on its behalf so long as the broker continues to meet the definition of "regulated person" throughout its engagement as a solicitor by the adviser.

For a broker-dealer to be a "regulated person" under rule 206(4)-5, the broker-dealer must be registered with the Commission and be a member of a registered national securities association that has a rule: (i) that prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made; and (ii) that the Commission finds both to impose substantially equivalent or more stringent restrictions on broker-dealers than rule 206(4)-5 imposes on investment advisers and to

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[315] Rule 206(4)-5(a)(2)(i) (which prohibits advisers and their covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party other than a regulated person to solicit a government entity for investment advisory services on behalf of such investment adviser). Rule 206(4)-5 defines a "regulated person" to include a "broker," as defined in section 3(a)(4) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)(4)] or a "dealer," as defined in section 3(a)(5) of that Act [15 U.S.C. 78c(a)(5)], that is registered with the Commission, and is a member of a registered national securities association registered under section 15A of that Act [15 U.S.C. 78o-3], *provided that* (A) the rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and (B) the Commission finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers than [rule 206(4)-5] imposes on investment advisers and that such rules are consistent with the objectives of [rule 206(4)-5]. The rule's definition of "regulated person" also includes certain investment advisers. *See infra* text accompanying note 323.

be consistent with the objectives of rule 206(4)-5.[316] We have included the requirement that a broker-dealer, in order to qualify as a regulated person, be subject to a pay to play rule of a registered national securities association of which it is a member so that brokers seeking to act as placement agents for investment advisers are, in turn, adequately deterred from engaging in pay to play activities on behalf of those advisers by such a rule.

FINRA has informed us that it is preparing rules for consideration that would prohibit its members from soliciting advisory business from a government entity on behalf of an adviser unless they comply with requirements prohibiting pay to play activities.[317] FINRA has said its rule would impose regulatory requirements on member brokers[318] "as rigorous and as expansive" as would be imposed on investment advisers by rule 206(4)-5, and that in developing its proposal it intends to "draw closely upon all the substantive and technical elements of the SEC's proposal as well as our regulatory expertise in examining and enforcing the MSRB rules upon which the SEC's proposal is

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316 Rule 206(4)-5(f)(9)(ii).

317 *See* Letter from Richard G. Ketchum, Chairman & Chief Executive Officer, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (Mar. 15, 2010), *available at* http://www.sec.gov/comments/s7-18-09/s71809-252.pdf ("Ketchum Letter") ("[w]e believe that a regulatory scheme targeting improper pay to play practices by broker-dealers acting on behalf of investment advisers is . . . a viable solution to a ban on certain private placement agents serving a legitimate function"). *See also* Letter from Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Richard G. Ketchum, Chairman & Chief Executive Officer, FINRA (Dec. 18, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-252.pdf.

318 As used in this Section, "broker" means a "broker" or "dealer," as each term is defined in section 3(a) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)].

based."[319] The rules, including any recordkeeping requirements, would be enforced by FINRA, which has substantial experience enforcing MSRB rules G-37 and G-38.[320]

For the Commission to adopt a rule prohibiting advisers from using placement agents until FINRA adopts a rule could impose substantial hardships on a significant number of advisers and solicitors that wrote to us. It could also disrupt pension funds' investment opportunities. Therefore, as we discuss in more detail below, we are delaying application of the prohibition on compensating third-party solicitors for one year from the effective date of this rule, in part to give FINRA time to propose such a rule.[321].

(2) Registered Investment Advisers

We are also permitting advisers covered by the rule to pay solicitors for government clients that are registered investment advisers subject to similar limitations.[322] Under the rule, a "regulated person" includes (in addition to a registered broker subject to the conditions described above), an investment adviser that is registered with the Commission under the Advisers Act, provided that the solicitor and its covered associates have not, within two years of soliciting a government entity: (i) made a contribution to an official of that government entity (other than a *de minimis* contribution, as permitted by the rule); or (ii) coordinated, or solicited any person (including a PAC) to

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319 Ketchum Letter.

320 *See* MSRB, *About the MSRB: Enforcement of Board Rules*, *available at* http://msrb.org/msrb1/whatsnew/default.asp ("Responsibility for examination and enforcement of Board rules is delegated to the Financial Industry Regulatory Authority for all securities firms, and to the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Comptroller of the Currency, and the Office of Thrift Supervision for banks.").

321 For a discussion of transition issues, see section III of this Release.

322 Rule 206(4)-5(a)(2)(i) (which prohibits advisers and their covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party other than a regulated person to solicit a government entity for investment advisory services on behalf of such investment adviser).

make, any contribution to an official of a government entity to which the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services, or payment to a political party of a state or locality where the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services to a government entity.[323]

We received comments urging us to permit advisers to compensate registered investment advisers for soliciting government officials, subject to rules or rule amendments the Commission could adopt under the Advisers Act.[324] We believe such an allowance is appropriate for similar reasons to those for permitting advisers to compensate broker-dealers subject to pay to play rules we have determined meet our objectives under rule 206(4)-5. We have direct oversight authority over investment advisers registered with us. Accordingly, we believe it is appropriate to allow them to act as third-party solicitors for other advisers. Therefore, the rule, as adopted, limits the advisers that another adviser may pay to solicit government entities on its behalf to those advisers that are registered with the Commission[325] and that have neither made the types of political contributions that would trigger the two-year time out nor otherwise engaged

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323 Rule 206(4)-5(f)(9)(i).

324 *See, e.g.*, IAA Letter.

325 We are not including within the definition of "regulated person" investment advisers registered solely with state securities authorities as some commenters suggested. *See id.* We do not have regulatory authority over those advisers as we do over advisers who are registered with us (and as we do over FINRA in connection with its oversight of brokers and dealers and enforcement of its own rules). In fact, such advisers are subject neither to our oversight nor to the recordkeeping rules we are adopting today.

in activities (*e.g.*, bundling of contributions) that the adviser could not engage in under the rule.[326]

Advisers compensating other advisers that qualify as "regulated persons" for soliciting government entities must adopt policies and procedures reasonably designed to prevent a violation of the rule.[327] Such policies and procedures should include, among other things, a careful vetting of candidates and ongoing review of "regulated person" investment advisers acting as solicitors currently being used. Such review would need to determine whether the adviser (and its covered persons) acting as a solicitor has made political contributions or otherwise engaged in conduct that would disqualify it from the definition of "regulated person" and thereby preclude the hiring adviser from paying it for the solicitation activity.

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326 Importantly, a person that is registered under the Exchange Act as a broker-dealer and under the Advisers Act as an investment adviser could potentially be a "regulated person" under the rule if it met the conditions for either prong of the definition. Such a regulated person should follow the rules that apply to the services it is performing, rather than complying with both investment adviser and broker-dealer pay to play requirements. The Exchange Act generally requires brokers and dealers to register with the Commission and become members of at least one self-regulatory organization. Exchange Act sections 15(a), 15(b)(8) [15 U.S.C. 78o(a), (b)(8)]. Section 3(a)(4)(A) of the Exchange Act generally defines a "broker" as any person engaged in the business of effecting transactions in securities for the account of others [15 U.S.C. 78c(a)(4)(A)]. *See, e.g., Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Exchange Act Release No. 44291, at n.124 (May 11, 2001) [66 FR 27759 (May 18, 2001)] ("Solicitation is one of the most relevant factors in determining whether a person is effecting transactions."); *Strengthening the Commission's Requirements Regarding Auditor Independence*, Exchange Act Release No. 47265, at n.82 (Jan. 28, 2003) [68 FR 6006 (Feb. 5, 2003)] (noting that a person may be "engaged in the business," among other ways, by receiving compensation tied to the successful completion of a securities transaction). *See also Persons Deemed Not to Be Brokers*, Exchange Act Release No. 22172, at sec. II.A (Jun. 27, 1985) [50 FR 27940 (Jul. 9, 1985)] (noting that attorneys, accountants, insurance brokers, financial service organizations and financial consultants are engaged in the business of effecting transactions in securities for the account of others if they are retained by an issuer specifically for the purpose of selling securities to the public and receive transaction based-compensation for their services).

327 *See* Advisers Act rule 206(4)-7 [17 CFR 275.206(4)-7] (requiring advisers to adopt and implement compliance policies and procedures).

(c) Restrictions on Soliciting and Coordinating Contributions and Payments

Rule 206(4)-5 prohibits advisers and covered persons from coordinating or soliciting[328] any person or PAC to make (i) any contribution[329] to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services,[330] or (ii) any payment[331] to a political party of a state or locality where

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328 Rule 206(4)-5(f)(10)(ii) (defining "solicit," with respect to a contribution or payment, as communicating, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.). Some commenters requested that we provide guidance regarding when an adviser would be deemed to be soliciting contributions for purposes of the rule. *See, e.g.*, Caplin & Drysdale Letter. An adviser that consents to the use of its name on fundraising literature for a candidate would be soliciting contributions for that candidate. Similarly, an adviser that sponsors a meeting or conference which features a government official as an attendee or guest speaker and which involves fundraising for the government official would be soliciting contributions for that government official. Whether a particular activity involves a solicitation or coordination of a contribution or payment for purposes of the rule will depend on the facts and circumstances, thus we have not attempted to draw a bright line. The MSRB takes a similar approach. *See* MSRB, *Solicitation of Contributions*, MSRB Interpretive Letter (May 21, 1999), *available at* http://msrb.org/msrb1/rules/interpg37.htm (determination of whether activity constitutes "soliciting" under rule G-37 is a facts and circumstances analysis). *See also supra* note 255.

329 In the case of the fundraising meeting or conference described as an example in note 328, expenses incurred by the adviser for hosting the event would be a contribution by the adviser, thereby triggering the two-year ban on the adviser receiving compensation for providing advisory services to the government entity over which that official has influence. *See* section II.B.2(a) of this Release. Such expenses may include, but are not limited to, the cost of the facility, the cost of refreshments, any expenses paid for administrative staff, and the payment or reimbursement of any of the government official's expenses for the event. The *de minimis* exception under rule 206(4)-5(b)(1) would not be available with respect to these expenses because they would have been incurred by the firm, not by a natural person. *See* MSRB, *Supervision When Sponsoring Meetings and Conferences Involving Issuer Officials*, MSRB Rule G-37 Interpretive Notice (Mar. 26, 2007), *available at* http://www.msrb.org/msrb1/rules/notg37.htm (rather than addressing meetings and conferences in its rules directly, the MSRB applies a facts and circumstances test on a case-by-case basis).

330 Rule 206(4)-5(a)(2)(ii). An investment adviser would be seeking to provide advisory services to a government entity when it responds to a request for proposal, communicates with a government entity regarding that entity's formal selection process for investment advisers, or engages in some other solicitation of investment advisory business of the government entity. A violation of paragraph (a)(2)(ii) of the rule would not trigger a two-year ban on the provision of investment advisory services for compensation, but would be a violation of the rule.

the investment adviser is providing or seeking to provide investment advisory services to a government entity.[332] These restrictions are intended to prevent advisers from circumventing the rule's prohibition on direct contributions to certain elected officials such as by "bundling" a large number of small employee contributions to influence an election, or making contributions (or payments) indirectly through a state or local political party.[333]

We received only a few comments on this provision. One supporter of our proposal asserted that it "would close an important gap in which contributions might be made indirectly to government officials for the purpose of influencing their choice of investment advisers."[334] Most commenters that addressed the provision focused on the prohibition relating to contributions and payments to state and local political parties where the adviser is providing, or seeking to provide, advisory services. One state official suggested that this prohibition would unfairly affect states with strict limitations

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331 A payment is defined as any gift, subscription, loan, advance, or deposit of money or anything of value. Rule 206(4)-5(f)(7). This definition is similar to the definition of "contribution," but broader, in the sense that it does not include limitations on the purposes for which such money is given (*e.g.*, it does not have to be made for the purpose of influencing an election). We are including the broader term "payments," as opposed to "contributions," here to deter an adviser from circumventing the rule's prohibitions by coordinating indirect contributions to government officials by making payments to political parties.

332 Rule 206(4)-5(a)(2)(ii). This provision prohibits, for example, an adviser from soliciting a payment to the political party of a state if the adviser is providing or seeking to provide advisory services to the state, but would not preclude that adviser from soliciting a payment to a local political party (as long as the adviser is not also providing or seeking to provide advisory services to a government entity in that locality). In these circumstances, the rule would, however, prohibit an adviser from soliciting the payment to a local political party as a means to indirectly make payments to the state party. *See* rule 206(4)-5(d).

333 We note that this provision is not limited to the bundling of employee contributions. Another example of conduct that would be prohibited by this section would be an adviser or its covered associates soliciting contributions from professional service providers.

334 Cornell Law Letter.

on individual contributions to candidates as they are now more reliant on party money for campaigns.[335] Another state official, however, explained the importance of the provision by pointing out that it is often difficult or impossible to differentiate between individuals seeking an office and the political party, which often merely passes contributions it receives on to the candidate, and may direct successful candidates to place pension business with contributors.[336]

We are adopting this provision, as proposed. These restrictions on soliciting and coordinating contributions and payments close what would otherwise be a potential gap in the rule as advisers could circumvent its limitations on direct contributions through soliciting and coordinating others to make contributions to influence an election or a government official's investment adviser selection process.[337] We disagree that this

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335 CT Treasurer Letter. In upholding restrictions targeted at a particular industry, courts have found that the loss of contributions from a small segment of the electorate "would not significantly diminish the universe of funds available to a candidate to a non-viable level." *Green Party of Conn. v. Garfield*, 590 F. Supp. 2d 288, 316 (D. Conn. 2008); *see also Preston v. Leake*, 629 F. Supp. 2d 517, 524 (E.D.N.C. 2009) (differentiating the "broad sweep of the Vermont statute" that "restricted essentially any potential campaign contribution" from a statute that "only applies to lobbyists"); *In re Earle Asphalt Co.*, 950 A.2d 918, 927 (N.J. Super. Ct. App. Div. 2008), *aff'd* 957 A.2d 1173 (N.J. 2008) (holding that a limitation on campaign contributions by government contractors and their principals did not have the same capacity to prevent candidates from amassing the resources necessary for effective campaigning as the statute in *Randall*). *See supra* note 68.

336 Reilly Letter.

337 We note that a direct contribution to a political party by an adviser or its covered associates would not violate the rule, unless the contribution was a means for the adviser to do indirectly what the rule would prohibit if done directly (for example, if the contribution was earmarked or known to be provided for the benefit of a particular government official). *See* section II.B.2(d) of this Release. The MSRB amended rule G-37 in 2005 to expand its prohibition on soliciting others to make, and on coordinating, payments to state and local political parties to close what the MSRB identified as a gap in which contributions were being made indirectly to officials through payments to political parties for the purposes of influencing their choice of municipal securities dealers. The MSRB had not previously been able to deter this misconduct, despite issuing informal guidance in both 1996 and 2003. *See Rule G-37: Request for Comments on Draft Amendments to Rule G-37(c), Relating to Prohibiting Solicitation and Coordination of*

prohibition would unfairly affect candidates in states that limit individual contributions, because the rule is non-discriminatory and would affect contributions (and payments) to all candidates equally that were being bundled or made through a gatekeeper for the benefit of an investment adviser seeking or doing business with the state or local government.

(d) Direct and Indirect Contributions or Solicitations

Rule 206(4)-5(d) prohibits acts done indirectly, which, if done directly, would violate the rule.[338] As a result, an adviser and its covered associates could not funnel payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the adviser as a means to circumvent the rule.[339] We emphasize, however, that contributions by these other persons would not

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Payments to Political Parties, and Draft Question and Answer Guidance Concerning Indirect Rule Violations, MSRB Notice 2005-11 (Feb. 15, 2005), *available at* http://www.msrb.org/msrb1/archive/2005/2005-11.asp ("Both the 1996 Q&A guidance and the 2003 Notice were intended to alert dealers and [municipal finance professionals] to the realities of political fundraising and guide them toward developing procedures that would lead to compliance with both the letter and the spirit of the rule. The MSRB continues to be concerned, however, that dealer, [municipal finance professional], and affiliated persons' payments to political parties, including "housekeeping", "conference" or "overhead" type accounts, and PACs give rise to at least the appearance that dealers may be circumventing the intent of Rule G-37."); *Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Approving Proposed Rule Change Concerning Solicitation and Coordination of Payments to Political Parties and Question and Answer Guidance on Supervisory Procedures Related to Rule G-37(d) on Indirect Violations*, Exchange Act Release No. 52496 (Sept. 22, 2005) (SEC order approving change to MSRB G-37 to prohibit soliciting or coordinating payments to political parties).

338 Paragraph (d) of the rule is substantially similar to section 208(d) of the Advisers Act [15 U.S.C. 80b-8(d)], which states, "It shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder." MSRB rule G-37 contains a similar provision. *See* MSRB rule G-37(d).

339 This provision would also cover, for example, situations in which contributions by an adviser are made, directed or funded through a third party with an expectation that, as a result of the contributions, another contribution is likely to be made by a third party to an

otherwise trigger the rule's two-year time out.[340] We received no comments on this aspect of the proposed rule and are adopting it as proposed.

(e) Covered Investment Pools

Rule 206(4)-5 includes a provision that applies each of the prohibitions of rule 206(4)-5 to an investment adviser that manages assets of a government entity through a hedge fund or other type of pooled investment vehicle ("covered investment pool").[341] For example, a political contribution to a government official that would, under the rule, trigger the two-year time out from providing advice for compensation to the government entity would also trigger a two-year time out from the receipt of compensation for the management of those assets through a covered investment pool. This provision extends the protection of the rule to public pension plans that increasingly access the services of

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"official of the government entity," for the benefit of the adviser. Contributions made through gatekeepers thus would be considered to be made "indirectly" for purposes of the rule. In approving MSRB rule G-37, the Commission stated: "[rule G-37(d)] is intended to prevent dealers from funneling funds or payments through other persons or entities to circumvent the [rule]'s requirements. For example, a dealer would violate the [rule] if it does business with an issuer after contributions were made to an issuer official from or by associated persons, family members of associated persons, consultants, lobbyists, attorneys, other dealer affiliates, their employees or PACs, or other persons or entities as a means to circumvent the rule. A dealer also would violate the rule by doing business with an issuer after providing money to any person or entity when the dealer knows that the money will be given to an official of an issuer who could not receive the contribution directly from the dealer without triggering the rule's prohibition on business." *Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule*, Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)].

340 Like MSRB rule G-37(d), rule 206(4)-5(d) requires a showing of intent to circumvent the rule in order for such persons to trigger the time out. *See Blount*, 61 F.3d at 948 ("In short, according to the SEC, the rule restricts such gifts and contributions only when they are intended as end-runs around the direct contribution limitations.").

341 *See* rule 206(4)-5(c). We discuss the types of pooled investment vehicles that are "covered investment pools" below at section II.B.2.(e)(1) of this release.

investment advisers through hedge funds and other types of pooled investment vehicles they sponsor or advise.

This provision will generally affect two common types of arrangements in which a government official is in a position to influence investment of funds in pooled investment vehicles. The first is the investment of public funds in a hedge fund or other type of pooled investment vehicle. The other is the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a "529 plan."[342]

An adviser that makes political contributions to steer assets to a pooled investment vehicle it manages facilitates fraud by implementing a government official's *quid pro quo* scheme.[343] Public pension plan beneficiaries are harmed when a government official violates the public trust, for example, by failing to disclose that the government official has directed the investment of the plan's assets in a pooled investment vehicle not because of the vehicle's financial merits but rather because the official has received a political contribution.[344] By engaging in such conduct, the adviser engages in a scheme to defraud the beneficiaries of the government plan or program.[345] Additionally, an investment adviser to a pooled investment vehicle that is an investment option in a government plan or program may prepare information about the pooled

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342 We note that if an adviser is selected by a government entity to advise a government-sponsored plan (regardless of whether the plan selects one of the pools the adviser offers or manages as an option available under its plan), the prohibitions of the rule *directly* apply. *See* rule 206(4)-5(a)(1) and (a)(2).

343 *SEC v. DiBella*, 587 F.3d 553, 568 (2d Cir. 2009).

344 *Id.* at 566.

345 *See id.* at 568–69; section 206(4) of the Advisers Act. *See also* Exchange Act rule 10b-5 [17 CFR 240.10b-5].

investment vehicle that may be used by plan officials to evaluate the vehicle and by pension plan beneficiaries to decide whether to allocate assets to the vehicle. Such an adviser engages in or facilitates an act, practice, or course of business which is fraudulent, deceptive, or manipulative when the adviser does not disclose that it made a contribution for the purpose of inducing an investment by the government officials and that the government officials sponsoring the plan chose the vehicle as an investment option for beneficiaries not solely on the basis of its merits, but rather as the consequence of improper *quid pro quo* payments.[346] The rule also operates to prevent an adviser from engaging in pay to play practices indirectly through an investment pool that it would not be permitted to do if it directly managed (or sought to directly manage) the assets of a government entity.[347]

Although a few commenters asserted that the rule or parts of it should not apply to pooled investment vehicles,[348] none made a persuasive argument that the problems the rule is designed to address are not present in the management of public pension plan and other public monies invested in pooled investment vehicles. As we discussed in the Proposing Release,[349] when a decision to invest public funds in a pooled investment vehicle is based on campaign contributions, the public pension plan may make inferior

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346 *See, e.g.*, *Oran v. Stafford*, 226 F.3d 275, 285-86 (3d Cir. 2000) ("a duty to disclose may arise when there is . . . an inaccurate, incomplete or misleading prior disclosure"); *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992) ("when a corporation does make a disclosure—whether it be voluntary or required—there is a duty to make it complete and accurate") (quoting *Roeder v. Alpha Industries, Inc.*, 814 F.2d 22, 26 (1st Cir. 1987). *See also* Exchange Act Rule 10b-5(b).

347 *See* rule 206(4)-5(d). *See also* section 208(d) of the Act.

348 *See, e.g.*, Comment Letter of Abbott Capital Management, LLC (Oct. 6, 2009) ("Abbott Letter"); ICI Letter; NY City Bar Letter; SIFMA Letter; Skadden Letter; Sutherland Letter.

349 *See* Proposing Release, at section II.A.3.(e)(2).

investment choices and may pay higher fees. And such pension plans may invest in pooled investment vehicles that pay substantially higher advisory fees and assume significantly greater risks than other investment alternatives.[350]

We find nothing in the structure of pooled investment vehicles or the variety of investment strategies they employ that suggests a reason for treating advisers to pooled investment vehicles differently from advisers to separately managed advisory accounts, except, as we discuss below, registered investment companies to which we apply a more limited version of the rule. That an investment in a pooled investment vehicle may not involve a direct advisory relationship with a government sponsored plan does not change the nature of the fraud or the harm that may be inflicted as a consequence of the adviser's pay to play activity.

Indeed, many of our recent enforcement cases alleged political contributions or kickbacks designed to induce public officials to invest public pension plan assets in pooled investment vehicles.[351] We are concerned that our failure to apply the rule to

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350 *See, e.g.*, Nanette Burns, *Can Retirees Afford This Much Risk?* BUSINESS WEEK (Sept. 17, 2007), *available at* http://www.businessweek.com/magazine/content/07_38/b4050048.htm (asserting that public pension plan assets are increasingly being invested in higher risk alternative investments, including hedge funds); Hannah M. Terhune, *Accounts Training*, MONEY SCIENCE (Dec. 11, 2006), *available at* http://www.moneyscience.com/Hedge_Fund_Tutorials/Hedge_Fund_Management_and_Performance_Fees.html (noting an "enormous difference in rewards for the managers of hedge funds versus those of mutual funds" because hedge fund managers are entitled to performance fees).

351 *See, e.g.*, *SEC v. Paul J. Silvester, et al.*, Litigation Release No. 16759, Civil Action No. 3:00-CV-19411 DJS (D. Conn.) (Oct. 10, 2000) (action in which investment adviser allegedly paid third-party solicitors who kicked back a portion of the money to the former Connecticut State Treasurer in order to obtain public pension fund investments in a hedge fund managed by the adviser); *SEC v. William A. DiBella, et al.*, Litigation Release No. 20498, Civil Action No. 3:04 CV 1342 (EBB) (D. Conn.) (Mar. 14, 2008) (consultant was found to have aided and abetted the former Connecticut State Treasurer in a pay to play scheme involving an investment adviser to a private equity fund who had paid third-party solicitors to obtain public pension fund investments in the fund). There are

advisers who manage assets through these vehicles would ignore an area where there has been considerable growth, both in the amount of public assets invested in such pooled investment vehicles and allegations of pay to play activity involving public pension plans.[352] We believe a failure to apply the rule in this area could, in some cases, even encourage the use of covered investment pools as a means of avoiding application of the rule.

Nonetheless, as described in more detail below, we have made several changes from the proposal to more narrowly tailor the applicability of the rule to pooled investment vehicles in order to achieve our regulatory purpose while reducing

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examples of pay to play activity in the context of pooled investment vehicles in other jurisdictions as well. *See, e.g.*, *supra* note 18 (listing various actions relating to the recent pay to play allegations surrounding the New York Common Retirement Fund). *See also Guilty Plea in Fraud Case Tied to New York Pension*, ASSOCIATED PRESS (Dec. 4, 2009), *available at* http://www.nytimes.com/2009/12/04/nyregion/04pension.html (describing the guilty plea of an adviser to a venture capital fund to charges that he helped his company land a lucrative deal with New York's public pension fund by giving nearly $1 million worth of illegal gifts to state officials).

352 *See, e.g.*, Investment Company Institute, *529 Plan Program Statistics, Mar. 2009* (Feb. 5, 2010), *available at* http://www.ici.org/research/stats/529s/529s_03-09 (indicating that 529 plan assets have increased from $8.6 billion in 2000 to $100.3 billion in the first quarter of 2009, and that 529 plan accounts have increased from 1.3 million in 2000 to 11.2 million in the first quarter of 2009); Investment Company Institute, *The U.S. Retirement Market, 2008*, 18 RESEARCH FUNDAMENTALS, No. 5 (June 2009), *available at* http://www.ici.org/pdf/fm-v18n5.pdf (indicating that 403(b) plan and 457 plan assets have increased from $627 billion in 2000 to $712 billion in the fourth quarter of 2008); SEI, *Collective Investment Trusts: The New Wave in Retirement Investing* (May 2008), *available at* https://longjump.com/networking/RepositoryPublicDocDownload?id=80031025axe139509557&docname=SEI%20CIT%20White%20Paper%205.08.pdf&cid=80031025&encode=application/pdf (citing Morningstar data indicating that collective investment trust assets nearly tripled from 2004 to 2007 and grew by more than 150 percent between 2005 and 2007 alone). *See also* Michael Marois, *CalPERS, Blackstone Clash over Placement Agent 'Jackpot' Fees*, BLOOMBERG (Apr. 7, 2010), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acPNrTn1q7pw (noting that placement agents working for private equity, hedge funds, venture capital and real estate firms typically earn the equivalent of 0.5 percent to 3 percent of the money they place under the management of their client, quoting California State Treasurer Bill Lockyer, a member of the CalPERS board, "[t]he contingency fees are too much of a jackpot for the placement agents . . . [they] invite corrupt practices").

compliance burdens that commenters brought to our attention. In addition, we have made certain clarifying changes to the rule, as described below.

(1) Definition of "Covered Investment Pool"

Under the rule, a "covered investment pool"[353] includes: (i) any investment company registered under the Investment Company Act of 1940 that is an investment option of a plan or program of a government entity; or (ii) any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act.[354] Accordingly, it includes such unregistered pooled investment vehicles as hedge funds, private equity funds, venture capital funds and collective investment trusts.[355] It also

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353 Rule 206(4)-5(f)(3).

354 15 U.S.C. 80a-3(c)(1), (7) or (11). We note that a bank maintaining a collective investment trust would not be subject to the rule if the bank falls within the exclusion from the definition of "investment adviser" in section 202(a)(11)(A) of the Advisers Act [15 U.S.C. 80b-2(a)(11)(A)]. A non-bank adviser that provides advisory services with respect to a collective investment trust in which a government entity invests, however, would be subject to the rule's prohibitions with respect to all of its government entity clients, including the collective investment trust in which a government entity invests, unless another exemption is available.

355 One commenter questioned the Commission's authority to apply the rule in the context of covered investment pools in light of the opinion of the Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). Sutherland Letter. That case created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act in certain cases where investors in a pool are defrauded by an investment adviser to that pool. *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)], (adopting rule 206(4)-8 [17 CFR 275.206(4)-8]). In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of ''client'' as used in that section, the Court of Appeals expressed the view that, for purposes of sections 206(1) and (2), the ''client'' of an investment adviser managing a pool is the pool itself, not an investor in the pool. In its opinion, the Court of Appeals distinguished sections 206(1) and (2) from section 206(4) of the Advisers Act, which applies to persons other than clients. *Id.* at n.6. *See also United States v. Elliott*, 62 F.3d 1304, 1311 (11th Cir. 1995). Section 206(4) permits us to adopt rules proscribing fraudulent conduct that is potentially harmful to investors in pooled investment vehicles. We are adopting rule 206(4)-5 under this authority.

includes registered pooled investment vehicles, such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.[356] These plans or programs may include college savings plans like "529 plans"[357] and retirement plans like "403(b) plans"[358] and "457 plans"[359] that typically allow participants to select among pre-established investment "options," or particular investment pools (often invested in registered investment companies or funds of funds, such as target date funds), that a government official has directly or indirectly selected to include as investment choices for participants.[360]

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356 Rule 206(4)-5(f)(8).

357 A 529 plan is a "qualified tuition plan" established under section 529 of the Internal Revenue Code of 1986 [26 U.S.C. 529]. States generally establish 529 plans as state trusts which are considered instrumentalities of states for federal securities law purposes. As a result, the plans themselves are generally not regulated under the federal securities laws and many of the protections of the federal securities laws do not apply to investors in them. *See* section 2(b) of the Investment Company Act [15 U.S.C. 80a-2(b) and section 202(b) of the Advisers Act [15 U.S.C. 80b-2(b) (exempting state-owned entities from those statutes). However, the federal securities laws do generally apply to, and the Commission does generally regulate, the brokers, dealers, and municipal securities dealers that effect transactions in interests in 529 plans. *See generally* sections 15(a)(1) and 15B of the Exchange Act [15 U.S.C. 78a-15(a)(1) and 15B]. A bank effecting transactions in 529 plan interests may be exempt from the definition of "broker" or "municipal securities dealer" under the Exchange Act if it can rely on an exception from the definition of broker in the Exchange Act. In addition, state sponsors of 529 plans may hire third-party investment advisers either to manage 529 plan assets on their behalf or to act as investment consultants to the agency responsible for managing plan assets. These investment advisers, unless they qualify for a specific exemption from registration under the Advisers Act, are generally required to be registered with the Commission as investment advisers and would therefore be subject to our rule.

358 A 403(b) plan is a tax-deferred employee benefit retirement plan established under section 403(b) of the Internal Revenue Code of 1986 [26 U.S.C. 403(b)].

359 A 457 plan is a tax-deferred employee benefit retirement plan established under section 457 of the Internal Revenue Code of 1986 [26 U.S.C. 457].

360 We would consider a registered investment company to be an investment option of a plan or program of a government entity where the participant selects a model fund or portfolio (such as an age-based investment option of a 529 plan) and the government entity selects the specific underlying registered investment company or companies in which the portfolio's assets are invested.

We proposed to include in the definition of "covered investment pool" the types of pooled investment vehicles that are likely to be used as funding vehicles for, or investments of, government-sponsored savings and retirement plans. We explained that we included registered investment companies because of the significant growth in government-sponsored savings plans in recent years, which increasingly use these funds as investment options,[361] and the increased competition among advisers for selection of their fund as an investment option for these plans.[362] We were concerned that advisers to pooled investment vehicles, including registered investment companies, may make political contributions to influence the decision by government officials to include their funds as options in such plans.

We recognized in our proposal, however, that an adviser to a registered investment company might have difficulty in identifying when or if a government investor was a fund shareholder for purposes of preventing the adviser (or its covered associates) from making contributions that would trigger a two-year time out.[363] Therefore, we proposed to only include publicly offered registered investment companies

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361 *See supra* note 352 and accompanying text.

362 *See, e.g.*, Charles Paikert, *TIAA-CREF Stages Comeback in College Savings Plans,* CRAIN'S NEW YORK BUS., Apr. 23, 2007 (depicting TIAA-CREF's struggle to remain a major player in managing State 529 plans because of increasing competition from the industry's heavyweights); Beth Healy, *Investment Giants Battle for Share of Exploding College-Savings Market*, BOSTON GLOBE, Oct. 29, 2000, at F1 (describing the increasing competition between investment firms for state 529 plans and increasing competition to market their plans nationally). *See also* AnnaMaria Andriotis, *529 Plan Fees are Dropping,* SMARTMONEY, Dec. 16, 2009, *available at* http://www.smartmoney.com/personal-finance/college-planning/529-plan-fees-are-dropping-but-for-how-long/?hpadref=1 ("Costs on these plans are falling for a few reasons, and the biggest one has little to do with the state of the economy: the nature of their contracts creates competition. When a contract for a state 529 plan expires, program managers compete against each other and may lower their fees to try to secure the new contract.").

363 *See* Proposing Release, at nn. 185-87 and accompanying text.

in the definition of covered investment pool for purposes of the two-year time out provision to the extent they were investments or investment options of a plan or program of a government entity.[364]

Several commenters asserted that an adviser to a publicly offered investment company would have similar difficulties in identifying government investors in registered investment companies for purposes of complying with other provisions of the rule.[365] One opposed application of the rule to registered investment companies "even if the [company] is not included in a plan or program of a government entity,"[366] although several generally urged us to exclude registered investment companies from the rule altogether.[367] Another commenter urged us to apply the rule's recordkeeping requirements (discussed below) prospectively and after a period of time that would be adequate to enable funds to redesign their processes and systems to capture information about whether an investor is a "government entity," which would be necessary to comply

364 *See* proposed rule 206(4)-5(f)(3) ("Covered investment pool means any investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) . . . except that for purposes of paragraph (a)(1) of this section, an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), the shares of which are registered under the Securities Act of 1933 (15 U.S.C. 77a), shall be a covered investment pool only if it is an investment or an investment option of a plan or program of a government entity.").

365 *See* Davis Polk Letter; Fidelity Letter; ICI Letter; NSCP Letter; Comment Letter of Standard & Poor's Investment Advisory Services LLC and Standard & Poor's Securities Evaluations, Inc. (Oct. 5, 2009) ("S&P Letter"); SIFMA Letter; T. Rowe Price Letter.

366 T. Rowe Price Letter.

367 Fidelity Letter; ICI Letter; NSCP Letter; SIFMA Letter. We disagree that registered investment companies should be excluded from our rule. Pay to play activity is fraudulent, regardless of whether it occurs in the context of a pooled investment vehicle or a separately managed account. One commenter asserted that the existence of a regulatory regime applicable to investment companies precludes the need for pay to play prohibitions with respect to these pools. *See* ICI Letter. However, existing laws and regulations applicable to investment companies do not specifically address pay to play practices.

with the rule and our proposed amendment to the Act's recordkeeping rule.[368] Some noted that identifying government investors would be particularly challenging when shares were held through an intermediary.[369]

We continue to believe for the reasons discussed above[370] and in the Proposing Release, that advisers to registered investment companies should be subject to the rule. In response to comments, we have modified our proposal to include a registered investment company in the definition of covered investment pool, for purposes of all three of the rule's pay to play prohibitions, but *only* if it is an investment option of a plan or program of a government entity.[371] We believe this approach strikes the right balance between applying the rule in those contexts, discussed in the Proposing Release,[372] in which advisers to registered investment companies may be more likely to engage in pay to play conduct, while recognizing the compliance challenges relating to identifying government investors in registered investment companies[373] that may result from a

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368 ICI Letter. *See also* section II.D of this Release.

369 *See* T. Rowe Price Letter; ICI Letter, Fidelity Letter.

370 *See supra* notes 361-362 and accompanying text.

371 Rule 206(4)-5(f)(3).

372 Proposing Release, at nn.185-87 and accompanying text. *See also supra* notes 352 and 362 and accompanying text (describing the growth in government-sponsored savings plans in recent years and the increased competition for an adviser's fund to be selected as an investment option of such a plan).

373 Identifying government investors in other types of covered investment pools does not generally present similar compliance challenges. *See, e.g.*, rule 2(a)(51) under the Investment Company Act [17 CFR 270.2(a)(51)] (defining "qualified purchaser," as that term is used in section 3(c)(7) of that Act); Rule 501(a) of Regulation D under the Securities Act of 1933 ("Securities Act") [17 CFR 230.501(a)] (defining "accredited investor" for purposes of limited offerings without registration under the Securities Act of 1933); and Advisers Act rule 205-3 (creating an exception from the prohibition against an adviser receiving performance-based compensation from clients that are not "qualified clients," and which is relied on by many advisers to funds that are exempt from Investment Company Act registration under section 3(c)(1) of that Act).

broader application of the rule. When an adviser's investment company is an investment option in a participant-directed government plan or program, we believe it is reasonable to expect the adviser will know (or can reasonably be expected to acquire information about) the identity of the government plan.[374] We recognize that when shares are held through an intermediary, an adviser may have to take additional steps to identify a government entity.[375] Therefore, we have provided advisers to registered investment companies with additional time to modify current systems and processes.[376]

We have also made several minor changes from our proposal intended to clarify and simplify application of the rule. First, at the suggestion of commenters,[377] we are clarifying that an adviser to a registered investment company is only subject to the rule—*i.e.*, the investment company is only considered a covered investment pool—if the investment company is an investment option of a plan or program of a government entity that is *participant-directed*.[378] This change reflects our intent, as demonstrated by the

374 With respect to a 529 plan, for example, an adviser would know that its investment company is an investment option of the plan and will know the identity of the government entity investor because a 529 plan can only be established by a state, which generally establishes a trust to serve as the direct investor in the investment company, while plan participants invest in various options offered by the 529 trust. The rule does not require an adviser to identify plan participants, only the government plan or program. *See* rule 206(4)-5(f)(5)(iii) (defining a "government entity" to include a plan or program of a government entity. The definition does *not* include the participants in those plans or programs).

375 For example, while 403(b) plans and 457 plans are generally associated with retirement plans for government employees, they are not used exclusively for this purpose. For instance, certain non-profit or tax-exempt entities can establish these types of plans. We also understand that it is not uncommon for contributions of 403(b) and 457 plans to be commingled into an omnibus position that is forwarded to the fund, making it more challenging for an adviser to distinguish government entity investors from others.

376 *See* section III.D of this Release. We received several letters addressing this concern. ICI Letter; T. Rowe Price Letter; Fidelity Letter.

377 *See, e.g.*, ICI Letter; Davis Polk Letter; SIFMA Letter.

378 Rule 206(4)-5(f)(8).

examples we give in the definition (*i.e.*, 529 plans, 403(b) plans, and 457 plans) that the definition is intended to encompass those covered investment pools that have been pre-selected by the government sponsoring or establishing the plan or program as part of a limited menu of investment options from which participants in the plan or program may allocate their account. We have also added, as additional examples to the definition of "government entity," a defined benefit plan and a state general fund to better distinguish these pools of assets from a plan or program of a government entity.[379] We have also made minor organizational changes within the definition of government entity from our proposal to make clear that such pools are not "plans or programs of a government entity."

Finally, we have simplified the definition of "covered investment pool" as it applies to registered investment companies. The definition as adopted includes investment companies registered under the Investment Company Act that are an option of a plan or program of a government entity, regardless of whether, as proposed, their shares are registered under the Securities Act of 1933 ("1933 Act"). As discussed above, under the rule as adopted an adviser to a registered investment company is only subject to the rule if the company is an investment option of a plan or program. As a result, we believe it is unnecessary to distinguish between registered investment companies based on whether their shares are registered under the 1933 Act, although we understand that those shares will typically be registered where the fund is an option in a plan or program of a government entity.

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[379] Rule 206(4)-5(f)(5).

(2) Application of the Rule

Under rule 206(4)-5 (and as proposed) an investment adviser is subject to the two-year time out if it manages a covered investment pool in which the assets of a government entity are invested.[380] The rule does not require a government entity's withdrawal of its investment or cancellation of any commitment it has made. Indeed, the rule prohibits advisers not from *providing advice* subsequent to a triggering political contribution, but rather from *receiving compensation* for providing advice. If a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year "time out" is made, the adviser must forgo any compensation related to the assets invested or committed by that government entity.[381]

Application of the two-year time out may present different issues for covered investment pools than for separately managed accounts due to various structural and legal differences. Having made a contribution triggering the two-year time out, the adviser may have multiple options available to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. For instance, in the case of a private pool, the adviser could seek to cause the pool to redeem the investment of the

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380 Rule 206(4)-5(c).

381 As we noted above and in the Proposing Release, the phrase "for compensation" includes both profits and the recouping of costs, so an adviser is not permitted to continue to manage assets at cost after a disqualifying contribution is made. Proposing Release, at n.191. *See also supra* note 137 and accompanying text. As we discussed above in section II.B.2(a)(1) of this Release, we are not persuaded by commenters who suggested permitting the adviser to be compensated at cost following payment of a triggering contribution or payment. *See, e.g.*, Dechert Letter; NY City Bar Letter. In our judgment, the potential loss of profits from the government client alone may be insufficient to deter pay to play activities. However, costs specifically attributable to the covered investment pool and not normally incurred in connection with a separately managed account, such as costs attributable to an annual audit of the pool's assets and delivery of its audited financial statements, would not be considered compensation to the adviser for these purposes.

government entity.[382] Such redemptions may be relatively simple matters in the case of, for example, a highly liquid private pool.[383] Commenters pointed out to us that, for some private pools, such as venture capital and private equity funds, a government entity's withdrawal of its capital or cancellation of its commitment may have adverse implications for other investors in the fund.[384] In such cases, the adviser could instead comply with the rule by waiving or rebating the portion of its fees or any performance allocation or carried interest attributable to assets of the government client.[385]

For registered investment companies, the options for restricting compensation involving government investors are more limited, due to both Investment Company Act

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382 To the extent the adviser may seek to cause the private pool to redeem the investment of a government entity investor under these circumstances, it should consider disclosing this as an investment risk in a private placement memorandum, prospectus or other disclosure document to current and prospective investors in such a fund. *See, e.g.*, Rule 502 of Regulation D under the Securities Act [17 CFR 230.502] (addressing disclosure obligations for non-accredited investors who purchase securities in a limited offering pursuant to rules 505 or 506 of Regulation D under the Securities Act [17 CFR 230.505 or 17 CFR 230.506].

383 We understand that other types of pooled investment vehicles, including private equity and venture capital funds, already have special withdrawal and transfer provisions related to the regulatory and tax considerations applicable to certain types of investors, such as those regulated by the Employee Retirement Income Security Act of 1974 ("ERISA") [29 U.S.C. 18]. *See generally* JAMES M. SCHELL, PRIVATE EQUITY FUNDS – BUSINESS STRUCTURE AND OPERATIONS (Law Journal Press 2000) (2010).

384 *See* Abbott Letter; ICI Letter; NY City Bar Letter.

385 As we noted in the Proposing Release, some commenters to our 1999 Proposal asserted that a performance fee waiver raises various calculation issues. *See* Proposing Release, at n.192. An adviser making a disqualifying contribution could comply with rule 206(4)-5 by waiving a performance fee or carried interest determined on the same basis as the fee or carried interest is normally calculated—*e.g.*, on a mark-to-market basis. For arrangements like those typically found in private equity and venture capital funds where the fee or carry is calculated based on realized gains and losses and mark-to-market calculations are not feasible, advisers could use a straight-line method of calculation which assumes that the realized gains and losses were earned over the life of the investment.

provisions and potential tax consequences.[386] In our proposal, we suggested one approach that would meet the requirements of the rule—an adviser of a registered investment company could waive its advisory fee for the fund as a whole in an amount approximately equal to fees attributable to the government entity.[387] One commenter agreed with our approach,[388] while another commenter suggested we could, alternatively, permit the government entity to continue to pay its portion of the advisory fee, but require the adviser to rebate that portion of the fee to the fund as a whole.[389] We believe either approach would meet the requirements of the rule we are adopting today.

(3) Subadvisory Arrangements

A number of commenters urged that we exclude from the rule subadvisers to covered investment pools because, being in a subordinate role to the adviser, they may have no involvement in the adviser's solicitation activities including no ability to identify government entities being solicited, and therefore should not be held accountable for the adviser's actions.[390] None of these commenters, however, indicated that a subadviser could not obtain from the adviser the information necessary to comply with the rule. Additionally, no commenter provided us with a basis to distinguish advisers from subadvisers that would be adequate to avoid undermining the prophylactic nature of our

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386 *See* Proposing Release, at n.193 and accompanying text. *See, e.g.*, rule 18f-3 under the Investment Company Act [17 CFR 270.18f-3]. Moreover, other regulatory considerations, such as those under ERISA, may impact these arrangements with respect to collective investment trusts.

387 This may also be done at the class level or series level for private funds organized as corporations.

388 ICI Letter.

389 NY City Bar Letter.

390 *See, e.g.*, IAA Letter; S&P Letter; Skadden Letter; Davis Polk Letter.

rule. "Subadviser" is not defined under the Act,[391] and significant variation exists in subadvisory relationships.[392] There is no readily available way to draw meaningful distinctions between advisers and subadvisers by, for example, looking at who controls marketing and solicitation activities,[393] who has an advisory contract directly with the government client,[394] or other factors. In addition, subadvisers generally have the same economic incentives as advisers to obtain new business and increase assets under management. We are concerned that under the approaches suggested by commenters, an adviser that sought to avoid compliance with the prophylactic provisions of our rule and engage in pay to play could organize itself to operate as a subadviser in such an arrangement. We therefore believe it is not appropriate to exclude subadvisers from the rule.

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391 "Subadviser" also is not defined under the Investment Company Act, which requires that both advisory and subadvisory contracts ("which contract, whether with such registered company or with an investment adviser of such registered company . . .") be approved by a vote of a majority of the outstanding voting securities of the registered investment company. *See* section 15(a) of the Investment Company Act [15 U.S.C. 80a-15(a)].

392 *See, e.g.*, Investment Company Institute, *Board Oversight of Subadvisers* (Jan. 2010), *available at* http://www.ici.org/pdf/idc_10_subadvisers.pdf (providing guidance to mutual fund boards of directors with respect to overseeing subadvisory arrangements and recognizing that "there is no one 'correct' approach to effective subadvisory oversight by fund boards" because there are a wide variety of potential subadvisory arrangements).

393 *See, e.g.*, Davis Polk Letter (suggesting that we limit the application of the prohibitions to a subadviser to a covered investment pool that has the ability to control the soliciting, marketing or acceptance of government clients); S&P Letter (suggesting that we limit the application of the prohibitions to a subadviser to a covered investment pool that: (1) has the ability to control the soliciting, marketing or acceptance of government clients; and (2) is not a related person of the investment adviser or distributor or other investment pool).

394 *See, e.g.*, IAA Letter; Skadden Letter. *See also* sections 2(a)(20) and 15(a) of the Investment Company Act (treating a subadviser as an adviser to a registered investment company even in the absence of a direct contractual relationship with the investment company).

We are, however, providing some guidance that may assist advisers in subadvisory and fund of funds arrangements in complying with the rule.[395] First, by the terms of the rule, if an adviser or subadviser makes a contribution that triggers the two-year time out from receiving compensation, the subadviser or adviser, as applicable, that did not make the triggering contribution could continue to receive compensation from the government entity,[396] unless the arrangement were a means to do indirectly what the adviser or subadviser could not do directly under the rule.[397] Second, advisers to underlying funds in a fund of funds arrangement are not required to look through the investing fund to determine whether a government entity is an investor in the investing fund unless the investment were made in that manner as a means for the adviser to do indirectly what it could not do directly under the rule.[398]

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395 *See, e.g.*, IAA Letter (requesting clarification as to how the rule would apply when an adviser becomes subject to the compensation ban after hiring a subadviser or vice versa). *See also* Fidelity Letter; MFA Letter; SIFMA Letter (each expressing concern about how the rule would apply in the fund of funds context).

396 We understand that, under some advisory arrangements, the government entity has a contract only with the adviser and not the subadviser. Under those circumstances, it would be consistent with the rule for an adviser that has triggered the two-year time out to pass through to the subadviser that portion of the fee to which the subadviser is entitled, as long as the adviser retains no compensation from the government entity and the subadviser (and its own covered associates) has not triggered a time out as well.

397 *See* Rule 206(4)-5(d). For instance, an adviser that hires an affiliated subadviser to manage a covered investment pool in which a government entity invests so that the adviser could make contributions to that government entity would be doing indirectly what it would be prohibited from doing directly under the rule. A subadviser would be providing "investment advisory services for compensation to a government entity" regardless of whether the subadviser is paid directly by the government entity or by the adviser.

398 *See* rule 206(4)-5(d).

(f) Exemptions

An adviser may apply to the Commission for an order exempting it from the two-year compensation ban.[399] Under this provision, which we are adopting as proposed, we can exempt advisers from the rule's time out requirement where the adviser discovers contributions that trigger the compensation ban only after they have been made, and when imposition of the prohibition is unnecessary to achieve the rule's intended purpose. This provision will provide advisers with an additional avenue by which to seek to cure the consequences of an inadvertent violation by the adviser that falls outside the limits of the rule's *de minimis* exception and exception for returned contributions,[400] such as when a disgruntled employee makes a greater than $350 contribution as he or she exits the firm. In determining whether to grant an exemption, we will take into account the varying facts and circumstances that each application presents. Among other factors, we will consider: (i) whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Advisers Act; (ii) whether the investment adviser, (A) before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of rule 206(4)-5; (B) prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and (C) after learning of the contribution, (1) has taken all available steps to cause the contributor involved in making the contribution which

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399 Rules 0-4, 0-5, and 0-6 under the Advisers Act [17 CFR 275.0-4, 0-5, and 0-6] provide procedures for filing applications under the Act, including applications under the rule 206(4)-5.

400 *See* sections II.B.2(a)(6) and (7) of this Release, describing exceptions to the two-year time out prohibition of the rule.

resulted in such prohibition to obtain a return of the contribution; and (2) has taken such other remedial or preventive measures as may be appropriate under the circumstances; (iii) whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment; (iv) the timing and amount of the contribution which resulted in the prohibition; (v) the nature of the election (*e.g.*, federal, state or local); and (vi) the contributor's apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.[401] We intend to apply these factors with sufficient flexibility to avoid consequences disproportionate to the violation, while effecting the policies underlying the rule.

We received limited comment on this provision. A few commenters suggested that the operation of the rule should toll until a decision is made about an applicant's request.[402] We are concerned that such an approach could encourage frivolous applications and encourage applicants to delay the disposition of their applications. As we explained in the Proposing Release, an adviser seeking an exemption could place into an escrow account any advisory fees earned between the date of the contribution triggering the prohibition and the date on which we determine whether to grant an exemption.[403] Some commenters recommended the rule build in a specified length of

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401 *See* Rule 206(4)-5(e). These factors are similar to those considered by FINRA and the appropriate bank regulators in determining whether to grant an exemption under MSRB rule G-37(i).

402 ICI Letter; Skadden Letter.

403 *See* Proposing Release, at n.199. The escrow account would be payable to the adviser if the Commission grants the exemption. If the Commission does not grant the exemption, the fees contained in the account would be returned to the government entity client. In contrast, MSRB rule G-37, on which rule 206(4)-5 is based, does not permit a municipal

time for the Commission to respond to requests for relief.[404] We recognize that applications for an exemptive order will be time-sensitive and will consider such applications expeditiously. We note that the escrow arrangements discussed above may lessen the hardship on advisers.

D. Recordkeeping

We are adopting amendments to rule 204-2 to require registered investment advisers that have government clients, or that provide investment advisory services to a covered investment pool in which a government entity investor invests, to make and keep certain records that will allow us to examine for compliance with new rule 206(4)-5.[405] The rule amendments reflect several changes from our proposal, which are discussed below. These requirements are similar to the MSRB recordkeeping requirements for brokers, dealers and municipal securities dealers.[406]

Amended rule 204-2 requires registered advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government

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securities dealer to continue to engage in municipal securities business with an issuer while an application is pending. *See* MSRB Rule G-37 Q&A, Question V.1.

404 IAA Letter; ICI Letter; NASP Letter (each suggesting all applications be granted if they are not acted upon in 30 days); Skadden Letter (suggesting a 45-day deadline).

405 Rule 204-2(a)(18) and (h)(1). An adviser is required to make and keep these records only if it provides investment advisory services to a government entity or if a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services. Advisers that solicit government clients on behalf of other advisers are also subject to the amended recordkeeping requirements. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act, however, are not subject to the recordkeeping requirements under amended 204-2 unless they do register with us, although as discussed earlier, *supra* note 92 and accompanying text, they are subject to rule 206(4)-5. Advisers keeping substantially the same records under rules adopted by the MSRB are not required to keep duplicate records. Rule 204-2(h)(1).

406 MSRB rule G-8(a)(xvi). The MSRB also requires certain records to be made and kept in accordance with disclosure requirements that our rule does not contain.

entity is an investor, to make and keep records of contributions made by the adviser and covered associates to government officials (including candidates), and of payments to state or local political parties and PACs.[407] The adviser's records of contributions and payments must be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment and whether a contribution was subject to rule 206(4)-5's exception for certain returned contributions.[408] The rule also requires an adviser that has government clients to make and keep a list of its covered associates,[409] and the government entities to which the adviser has provided advisory services in the past five years.[410] Similarly, advisers to covered investment pools must make and keep a list of government entities that invest, or have invested in the past five years, in a covered investment pool, including any government entity that selects a covered investment pool to be an option of a plan or program of a government entity, such as a 529, 457 or 403(b) plan.[411] An investment adviser, regardless of whether it currently has a government client, must also keep a list of the names and business addresses of each regulated person to whom the adviser provides or agrees to provide,

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[407] Contributions and payments by PACs controlled by the adviser or a covered associate would also have to be recorded as these PACs are "covered associates" under the rule. Rule 206(4)-5(f)(2)(iii). *See* section II.B.2(a)(4) of this Release.

[408] Rule 204-2(a)(18)(ii).

[409] The adviser must record the name, title(s), and business and residence addresses of each covered associate. Rule 204-2(a)(18)(i)(A).

[410] Advisers do not have to maintain a record of government entities that were clients before the effective date. For additional information regarding the implementation of rule 206(4)-5, see section III of this Release.

[411] Amended rule 204-2 does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. *See supra* note 374. Consistent with changes we have made to the definition of covered investment pool, we note that an adviser's recordkeeping obligations with respect to a registered investment company apply only if such an investment company is an option of a plan or program of a government entity. *See* section II.B.2(e) of this Release.

directly or indirectly, payment to solicit a government entity on its behalf.[412] The amended rule reflects several changes from our proposal, which we describe below.

First, in response to comments,[413] we have limited the rule to provide that only records of contributions,[414] not payments,[415] to government officials and candidates are required to be kept under the rule.[416] We have made this change because, unlike contributions, which are one type of payment, all payments do not trigger the two-year time out. As a result of this change, the recordkeeping obligations better reflect the activities of an adviser or a covered associate that could result in the adviser being subject to the two-year time out. Commenters also argued that we should not require, as proposed, advisers to maintain records of payments to PACs.[417] Although those payments do not trigger application of the two-year time out, payments to PACs can be a means for an adviser or covered associate to funnel contributions to a government official without directly contributing. We are, therefore, adopting the amendment to require advisers to keep records of payments to PACs as these records will allow our staff to identify situations that might suggest an intent to circumvent the rule.[418]

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412 Rule 204-2(a)(18)(i)(D).

413 Fidelity Letter; IAA Letter; SIFMA Letter.

414 *See supra* note 153 and accompanying text (defining "contribution")

415 *See supra* note 331 (defining "payment").

416 Rule 204-2(a)(18)(i)(C).

417 *See, e.g.*, IAA Letter; SIFMA Letter.

418 Accordingly, as part of a strong compliance program, an adviser or covered associate that receives a general solicitation to make a contribution to a PAC should consider inquiring about how the collected funds would be used to determine whether the PAC is closely associated with a government official to whom a direct contribution would subject the adviser to the two-year time out. *See* section II.B.2(d) of this Release and rule 206(4)-5(d). The MSRB takes a similar approach regarding whether a payment to a PAC is an indirect contribution to a government official. *See* MSRB Rule G-37 Q&A, Questions III.4 and III.5.

Second, an investment adviser to a registered investment company must maintain records identifying government entity investors only if the investments are made as part of a plan or program of a government entity or provide participants in the plan or program with the option of investing in the fund.[419] This change would narrow the records required to those necessary to support the rule as modified from our proposal, and we believe addresses commenters' concerns regarding the ability of advisers to registered investment companies to identify government entity investors.[420] As discussed above, we believe it is reasonable to expect advisers to know the identity of the government entity when a registered fund they advise is part of a plan or program. In addition, as commenters suggested, we are providing a substantial transition period for advisers to registered investment companies that should allow these advisers to make the necessary changes to account documents and systems to allow them to identify government entities that provide one or more of the investment companies they advise as an investment option.[421]

Third, the amended rule requires an adviser to maintain a list of only those government entities to which it provides, or has provided in the past five years,

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419 Rule 204-2(a)(18)(i)(B). Amended rule 204-2 does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. For a discussion of the application of the rule to a covered investment pool that is an option of a government plan or program, see *supra* note 371 and accompanying text. Consistent with changes we have made to the definition of covered investment pool, we note that an adviser's recordkeeping obligations with respect to a registered investment company apply only if such an investment company is an option of a plan or program of a government entity. *See* section II.B.2(e) of this Release.

420 Advisers to covered investment pools that are relying on Investment Company Act exclusions in sections 3(c)(1), 3(c)(7) and 3(c)(11) must identify government entity investors regardless of whether they are an investment option of a plan or program of a government entity. Rule 204-2(a)(18)(i)(B).

421 *See* section III of this Release.

investment advisory services.[422] We are not requiring, as proposed, a list of government entities the adviser solicited for advisory business.[423] Some commenters expressed concerns about the potential scope of this requirement and noted that solicitation does not trigger rule 206(4)-5's two-year time out, rather it is providing advice for compensation that does so.[424] In light of these concerns, and the record before us today, we are not requiring advisers to maintain lists of government entities solicited that do not become clients.

Fourth, as discussed above, rule 206(4)-5 permits an adviser to use certain third parties to solicit on its behalf. We are, therefore, requiring that advisers that provide or agree to provide, directly or indirectly, payment to advisers or broker-dealers registered with the Commission that act as regulated persons under rule 206(4)-5 to maintain a list of the names and business addresses of each such regulated person.[425] These records will enable the Commission's staff to review and compare the regulated person's records to those of the adviser that hired the regulated person.

Finally, the amendments require advisers to make and keep records of their covered associates, and their own and their covered associates' contributions, *only if* they provide advisory services to a government client.[426] Commenters had expressed concerns that requiring advisers with no government business to make and keep these records

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422 *See* rule 204-2(a)(18)(i)(B).

423 *See* proposed rule 204-2(a)(18)(i)(B).

424 Dechert Letter; SIFMA Letter; Skadden Letter.

425 Rule 204-2(a)(18)(i)(D). If an adviser does not specify which types of clients the regulated person should solicit on its behalf (*e.g.*, that it should *only* solicit government entities), the adviser could satisfy this requirement by maintaining a list of all of its regulated person solicitors. *Supra* note 412.

426 Rule 204-2(a)(18)(iii).

could be unnecessarily intrusive to employees and burdensome on advisers.[427] In light of those concerns, and the record before us today, we are not requiring advisers with no government business to make and keep these records.[428] As a consequence, an adviser with no government clients would not have to require employees to report their political contributions.

E. Amendment to Cash Solicitation Rule

We are adopting, as proposed, a technical amendment to rule 206(4)-3 under the Advisers Act, the "cash solicitation rule." That rule makes it unlawful, except under specified circumstances and subject to certain conditions, for an investment adviser to make a cash payment to a person who directly or indirectly solicits any client for, or refers any client to, an investment adviser.[429]

Paragraph (iii) of the cash solicitation rule contains general restrictions on third-party solicitors that cover solicitation activities directed at *any* client, regardless of whether it is a government entity client. New paragraph (e) to rule 206(4)-3 alerts

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427 IAA Letter; Dechert Letter; SIFMA Letter.

428 Although advisers that do not have government entity clients are not required to maintain records under the amendments, the look-back requirements of rule 206(4)-5 continue to apply. As a result, an adviser that has not maintained records of the firm's and its covered associates' contributions would have to determine whether any contributions by the adviser, its covered associates, and any former covered associates would subject the firm to the two-year time out prior to accepting compensation from a new government entity client. The same applies to newly-formed advisers. The records an adviser develops during this determination process, would fall under the adviser's obligation to maintain records of all direct or indirect contributions made by the investment adviser or its covered associates to an official of a government entity, or payments to a political party of a state or political subdivision thereof, or to a political action committee. Rule 204-2(a)(18)(i)(C).

429 17 CFR 275.206(4)-3.

advisers and others that special prohibitions apply to solicitation activities involving government entity clients under rule 206(4)-5.[430]

III. EFFECTIVE AND COMPLIANCE DATES

Rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3 are effective on [insert date 60 days after publication in Federal Register]. Investment advisers subject to rule 206(4)-5 must be in compliance with the rule on [insert date six months after the effective date]. Investment advisers may no longer use third parties to solicit government business except in compliance with the rule on [insert date one year after the effective date].[431] Advisers to registered investment companies that are covered investment pools must comply with the rule by [insert date one year after the effective date].[432] Advisers subject to rule 204-2 must comply with amended rule 204-2 on [insert date six months after the effective date]. However, if they advise registered investment companies that are covered investment pools, they have until [insert date one year after the effective date] to comply with the amended recordkeeping rule with respect to those registered investment companies.

A. Two-Year Time Out and Prohibition on Soliciting or Coordinating Contributions

We are providing advisers with a six month transition period to give them time to identify their covered associates and current government entity clients and to modify their compliance programs to address new compliance obligations under the rule.[433]

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430 Rule 206(4)-3(e). We received no comments on this proposed amendment.

431 Rule 206(4)-5(a)(2).

432 Rule 206(4)-5(f)(3).

433 Section III.D of this Release addresses when advisers to "covered investment pools" that are registered investment companies must comply with the rule; section III.E of this

Accordingly, rule 206(4)-5's prohibition on providing advisory services for compensation within two years of a contribution will not apply to, and the rule's prohibition on soliciting or coordinating contributions will not be triggered by contributions made before [insert date six months after the effective date].[434] We believe that the length of the transition period should address commenters' concerns that advisers have sufficient time to implement policies and procedures regarding contributions to avoid violations of the rule and that the rule not affect the 2010 elections for which some advisory personnel may already have committed to make political contributions.[435]

B. Prohibition on Using Third Parties to Solicit Government Business and Cash Solicitation Rule Amendment

Advisers must comply with the new rule's prohibition on making payments to third parties to solicit government entities for investment advisory services on [insert date one year after the effective date].[436] Before this compliance date, advisers are not

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Release addresses transition considerations specific to certain other pooled investment vehicles.

434 Likewise, these prohibitions do not apply to contributions made before [insert date six months after the effective date] by new covered associates to which the look back applies. See section II.B.2(a)(5) of this Release for a discussion of the rule's look-back provision. For example, if an individual who becomes a covered associate of an adviser on or after [insert date six months after the effective date] made a contribution before [insert date six months after the effective date], that new covered associate's contribution would not trigger the two-year time out for the adviser. On the other hand, if an individual who later becomes a covered associate made the contribution on or after [insert date six months after the effective date], the contribution would trigger the two-year time out for the adviser if it were made less than, as applicable, six months or two years before the individual became a covered associate.

435 Commenters recommended that we provide advisers with six months to one year as a transition for rule 206(4)-5. *See* Davis Polk Letter; MFA Letter; ICI Letter; IAA Letter; NASP Letter; Skadden Letter.

436 Rule 206(4)-5(a)(2).

prohibited by the rule from making payments to third-party solicitors regardless of whether they are registered as broker-dealers or investment advisers.[437]

We have provided an extended transition period to provide advisers and third-party solicitors with sufficient time to conform their business practices to the new rule, and to revise their compliance policies and procedures to prevent violation of the new rule. In addition, the transition period will provide an opportunity for a registered national securities association to propose a rule that would meet the requirements of rule 206(4)-5(f)(9)(ii)(B) and for the Commission to consider such a rule. If, after one year, a registered national securities association has not adopted such rules, advisers would be prohibited from making payments to broker-dealers for distribution or solicitation activities with respect to government entities, but would be permitted to make payments to registered investment advisers that meet the definition of "regulated person" under the rule.[438] We understand from our staff, however, that FINRA plans to act within the timeframe; if they do not, we will consider whether we should take further action.

Finally, the compliance date for the technical amendment to the cash solicitation rule, rule 206(4)-3, which is intended to alert advisers that rule 206(4)-5 is applicable to solicitations of a government entity, is one year from the effective date, as the amendment to the cash solicitation rule need only be operative when rule 206(4)-5's third-party solicitor provisions are in effect.

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437 We note, however, that the antifraud provisions of the federal securities laws continue to apply during the transition period.

438 *See* rule 206(4)-5(f)(9)(i).

C. Recordkeeping

As discussed above, the amendments to rule 204-2 apply only to investment advisers with clients who are government entities. Such advisers must comply with the amended rule on [insert date six months after the effective date] except as noted below. By [insert date six months after the effective date], these advisers must begin to maintain records of all persons who are covered associates under the rule and keep records of political contributions they make on and after that date. Advisers must also make and keep a record of all government entities that they provide advisory services to on and after [insert date six months after the effective date]. Advisers are not, however, required to look back for the five years prior to the effective date to identify former government clients. Advisers that pay regulated persons to solicit government entities for advisory services on their behalf must make and keep a list of those persons beginning on and after [insert date one year after effective date].[439]

D. Registered Investment Companies

Advisers to registered investment companies that are "covered investment pools" under the rule[440] must comply with rule 205(4)-5 with respect to those covered pools [insert date one year after effective date]. During the transition period, contributions by the adviser or its employees to government entity clients that have selected an adviser's

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[439] Rule 204-2(a)(18)(i)(D).

[440] A registered investment company is only a covered investment pool if it is an investment option of a plan or program of a government entity, such as a 529 plan, 403(b) plan or 457 plan. *See* rule 206(4)-5(f)(3).

registered investment company as an investment option of a plan or program will not trigger the prohibitions of rule 206(4)-5.[441]

We have provided for an extended compliance date to respond to concerns expressed by commenters that an adviser to a registered investment company may require additional time to identify government entities that have selected that registered investment company as an investment option when shares of the fund are held through omnibus arrangements such that the identity of the fund investor is not readily available to the adviser.[442] The changes we have made to the proposed rule that limit the application of the two-year time out with respect to registered investment companies to those that are options in a plan or program of a government entity,[443] together with this extended compliance date should provide advisers to registered investment companies sufficient time to put into place those system enhancements or business arrangements, such as those with intermediaries, that may be necessary to identify those government plans or programs in which the funds serve as investment options.[444]

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441 Advisers to covered investment pools other than registered investment companies—*i.e.*, companies that would be investment companies under section 3(a) of the Investment Company Act but for the exclusion provided from that definition by either section 3(c)(1), section 3(c)(7) or section 3(c)(11)—are subject to the six-month transition period. We believe advisers to these types of funds, because the interests in them are typically held in the name of the investor, should be able to identify government entities without significant difficulty.

442 *See* ICI Letter; T. Rowe Price Letter.

443 *See* section II.B.2(a) of this Release.

444 A few commenters recommended that the rule apply only to new government investors in registered investment companies after the effective date of the rule. *See* ICI Letter; T. Rowe Price Letter. We do not believe this would be appropriate because pay to play can be just as troubling in the context of an adviser renewing an advisory contract (or including a registered investment company as an investment option in a plan or program) as one that is endeavoring to obtain business for the first time.

As noted above, we are providing for an extended compliance date for advisers that manage registered investment companies that are covered investment pools under the rule, which we are applying, for the same reasons, to recordkeeping obligations that arise as a result of those covered investment pools. Thus, advisers to these covered investment pools must make and keep a record of all government entity investors on and after [insert date one year after the effective date].[445]

IV. COST-BENEFIT ANALYSIS

We are sensitive to the costs and benefits imposed by our rules, and understand that there will be costs associated with compliance with rule 206(4)-5 and the amendments to rule 204-2.[446] We recognize that the rule and amendments will place burdens on advisers that provide or seek to provide advisory services to government entities, and that advisers may in turn choose to limit the ability of certain persons associated with an adviser to make contributions to candidates for certain offices and to solicit contributions for certain candidates and payments to political parties. We believe there are practical, cost-effective means to comply with the rule without an adviser imposing a blanket ban on political contributions by its covered associates. We have closely drawn the rule, and modified it based on comments received, to achieve our goal of addressing adviser participation in pay to play practices, while seeking to limit the burdens imposed by the rule.

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445 Amended rule 204-2 does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. *See supra* note 411.

446 As proposed, we are also making a conforming technical amendment to rule 206(4)-3 to address potential areas of conflict with proposed rule 206(4)-5. We do not believe that this technical amendment affects the costs associated with the rulemaking. It will benefit advisers because it provides clarity about the application of our rules when they potentially overlap.

The rule and rule amendments are designed to address pay to play practices by investment advisers that provide advisory services to government entity clients and to certain covered investment pools in which a government entity invests. The rule prohibits an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. The rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party that is not a "regulated person" for a solicitation of advisory business from any government entity, or for a solicitation of a government entity to invest in certain covered investment pools, on behalf of such adviser. Additionally, the rule prevents an adviser from coordinating or soliciting from others contributions to certain elected officials or candidates or payments to certain political parties. The rule applies both to advisers registered with us (or required to be registered) and those that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)). Our amendment to rule 204-2 requires a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees, as well as records of the regulated persons the adviser pays or agrees to pay to solicit government entities on the adviser's behalf.

In the Proposing Release, we requested comment on the effects of the proposed rule and rule amendments on pension plan beneficiaries, participants in government plans or programs, investors in pooled investment vehicles, investment advisers, the advisory profession as a whole, government entities, third party solicitors, and political action committees.[447] We requested that commenters provide analysis and empirical data to support their views on the costs and benefits associated with the proposal. For example, we requested comment on the costs of establishing compliance procedures to comply with the proposed rule, both on an initial and ongoing basis and on the costs of using compliance procedures of an affiliated broker-dealer that the broker-dealer established as a result of MSRB rules G-37 and G-38. In addition, we requested data regarding our assumptions about the number of unregistered advisers that would be subject to the proposed rule, and the number of covered associates of these exempt advisers. Finally, in the context of the objectives of this rulemaking, we sought comments that address whether these rules will promote efficiency, competition and capital formation, and what effect the rule would have on the market for investment advisory services and third-party solicitation services.

We received approximately 250 comment letters on the proposal. Almost all of the commenters agreed that pay to play is a serious issue that should be addressed. One commenter stated that "the benefits derived from the application of pay to play limitations to public sector advisory services will far outweigh any temporary dislocations that may occur as private and public sector professionals make the necessary adjustments to their activities to transition to the Commission's new standards."[448] Many, however, expressed concern about costs,[449] particularly those related to the proposed ban on payments to third parties. Some suggested that the Commission underestimated the

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447 Proposing Release, at section III.C.

448 MSRB Letter. *See also* Thompson Letter; Common Cause Letter; Fund Democracy/Consumer Federation Letter (each identifying benefits of the rule).

449 *See, e.g.*, Davis Polk Letter (generally commenting that any benefits of the proposed rule were outweighed by its likely costs). *See also* ICI Letter; Monument Group Letter.

costs of compliance with the rule and rule amendments.[450] As discussed below, many of the commenters that did comment specifically on the costs and benefits of the proposal did not provide empirical data to support their views.

A. Benefits

As we discuss extensively throughout this Release, we expect that rule 206(4)-5 will yield several important direct and indirect benefits. Overall, the rule is intended to address pay to play relationships that interfere with the legitimate process by which advisers are chosen based on the merits rather than on their contributions to political officials. The potential for fraud to invade the various, intertwined relationships created by pay to play arrangements is without question. We believe that rule 206(4)-5 will reduce the occurrence of fraudulent conduct resulting from pay to play and thus will achieve its goals of protecting public pension plans, beneficiaries, and other investors from the resulting harms. One commenter who agreed with us commended the proposed rule as a "strong start in controlling corruption, balancing the rights of the advisors and

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450 *See, e.g.*, SIFMA Letter ("While SIFMA believes that addressing practices that potentially undermine the merit-based selection of investment advisers is an important and laudable effort, the SEC appears to have underestimated the compliance costs the Proposed Rule will impose on covered parties."); ICI Letter ([I]n relying on the estimates for compliance with the MSRB rules, the Commission significantly underestimates the compliance and recordkeeping burdens associated with the proposed rule."); Davis Polk Letter ("We believe that the Commission may have substantially underestimated the number of investment advisers that will be affected by the Proposed Rule and its costs and market effects in concluding that many of the aspects of the Rule would impose only minimal additional costs and burdens on investors and investment advisers."). The commenters who addressed our estimates, however, did so in general terms and did not provide specific suggestions as to how they should be modified. See the discussion below regarding changes from the proposed rule that we believe mitigate some of the costs.

their executives with the very real detriment to the public which the numerous cases of pay-to-play involving public pension funds and other public entities have caused."[451]

Addressing pay to play practices will help protect public pension plans and investments of the public in government-sponsored savings and retirement plans and programs by addressing situations in which a more qualified adviser may not be selected, potentially leading to inferior management, diminished returns or greater losses. One commenter who agreed, observed, "[w]hen lucrative investment contracts are awarded to those who pay to play, public pension funds may end up receiving substandard services and higher fees, resulting in lower earnings."[452] One public official commenter detailed the role of pay to play arrangements in the selection of public pension fund managers and the harm it can inflict on the affected plans,[453] while other officials wrote to us explicitly expressing support for a Commission rule.[454] By addressing pay to play practices, we will help level the playing field so that the advisers selected to manage retirement funds and other investments for the public are more likely to be selected based on the quality of their advisory services. These benefits, although difficult to quantify, could result in substantial savings and better performance for the public pension plans, their

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451 Common Cause Letter.

452 Bloomberg Letter.

453 Weber Letter ("I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen."). *See also* Pohndorf Letter (noting that when the sole trustee of a major pension fund changed several years ago, a firm managing some of the fund's assets "began to receive invitations to fundraising events for the new trustee with suggested donation amounts"); Tobe Letter (suggesting the negative effects of pay to play activities on the Kentucky Retirement System's investment performance).

454 *See, e.g.*, DiNapoli Letter; Bloomberg Letter.

beneficiaries, and participants.[455] Two commenters noted that the rule would promote the interests of plan beneficiaries.[456]

By leveling the playing field among advisers competing for state and local government business, the rule will help minimize or eliminate manipulation of the market for advisory services provided to state and local governments.[457] For example, direct political contributions or payments made to third-party solicitors as part of pay to play practices create artificial barriers to competition for firms that cannot, or will not, make those contributions or payments.[458] They also increase costs for firms that may feel they have no alternative but to pay to play. The rule addresses a collective action problem created by this dynamic analogous to the one identified in the *Blount* opinion.[459] One commenter emphasized the importance of restoring public confidence in the investment

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455 According to the most recently available US census data, as of 2008, there are 2,550 state and local government employee retirement systems. http://www.census.gov/govs/retire/. *See also* Fund Democracy/Consumer Federation Letter ("These practices adversely affect the economic interests of millions of America's public servants.").

456 Comment Letter of John C. Emmel (Sept. 18, 2009) ("one more step to foster a level playing field for investors . . . where advisors' priorities trump those of the investing public"); Comment Letter of George E. Kozel (Aug. 31, 2009) ("Kozel Letter") ("Their interests lie in obtaining the highest fees not in producing benefits for the pensioners . . . .").

457 *See* DiNapoli Letter (advocating for a "level playing field for investors and investment advisers that protects the integrity of the decision-making process [for hiring an investment adviser]"); Bloomberg Letter ("Pay to play practices clearly undermine the open competitive process by which government contracts are to be awarded.").

458 *See supra* note 453.

459 *See Blount*, 61 F.3d at 945-46 (discussing the harms of pay to play: "Moreover, there appears to be a collective action problem tending to make the misallocation of resources persist."). *See also* text accompanying notes 291-294 of this release. Collective action problems are a class of market failures calling for a regulatory response, and exist, for example, where participants may prefer to abstain from an unsavory practice (such as pay to play), but nonetheless participate out of concern that, even if they abstain, their competitors will continue to engage in the practice profitably and without adverse consequences.

activities of all public pension funds.[460] Indeed, at its core, the rulemaking addresses practices that undermine the integrity of the market for advisory services, as underscored by another commenter.[461]

Allocative efficiency is enhanced when government clients award advisory business to advisers that compete based on price, performance and service and not the influence of pay to play, which in turn enables advisory firms, particularly smaller advisory firms, to compete on merit, rather than their ability or willingness to make contributions.[462] In addition, taking into account the effects of analogous practices in the underwriting of municipal securities prior to MSRB rule G-37,[463] we believe a merit-based competitive process may result in the allocation of public pension monies to different advisers who may well deliver better investment performance and lower advisory fees than those advisers whose selection was influenced by pay to play.

As adopted, the rule contains a prohibition against advisers directly or indirectly compensating a third party to solicit government entities on its behalf, unless the third-party solicitor is a "regulated person" subject to pay to play restrictions. This exception

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460 Thompson Letter. *See also* Bloomberg Letter.

461 Common Cause Letter ("Pay-to-play has not only the potential to compromise an investment adviser's ethical and legal duties under the Investment Advisers Act of 1940, but in several high profile cases across the nation, has already done so, negatively impacting the public perception of government decision making and, in some cases, costing the taxpayer millions of dollars and placing billions of dollars in pension funds at risk."). *See also* Dempsey Letter (noting applause for efforts "to stop the 'pay-to-play' practice which only serves to undermine public trust in investment advisors and regulators").

462 *See* Comment Letter of Budge Collins (Sept. 30, 2009) (the rule would "level the playing field for the rest of us who have never made contributions to elected officials who sit on investment management committees").

463 One commenter cited a study containing evidence that before rule G-37 was adopted, underwriters' pay to play practices distorted underwriting fees as well as which firms were hired by government issuers. *See* Butler Letter.

enables advisers and pension plans (and their beneficiaries) to continue to benefit from the services of third-party solicitors, such as the placement of interests in private funds, while at the same time benefitting from a Commission rule that prohibits pay to play practices.[464]

Our rule may also benefit pension plans by preventing harms that can result when an adviser is not negotiating at arm's length with a government official. For example, as a result of pay to play, an adviser may obtain greater ancillary benefits, such as "soft dollars," from the advisory relationship, which may be directed for the benefit of the adviser, potentially at the expense of the pension plan, thereby using a pension plan asset for the adviser's own purposes.[465] Additionally, taxpayers may benefit from our rule because they might otherwise bear the financial burden of bailing out a government pension fund that has ended up with a shortfall due to poor performance or excessive fees that might result from pay to play.[466]

In addition to the general benefits of addressing pay to play practices by investment advisers noted above, we believe the specific provisions of the rule, including the two-year time out, the ban on using third parties to solicit government business, and

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464 Commenters, both on the Proposing Release and our 1999 proposal, argued that treating third-party solicitors as covered associates would create significant compliance challenges because these solicitors were not controlled by advisers. *See supra* note 264 and accompanying text.

465 *See supra* note 55 and accompanying text.

466 *See* Kozel Letter (supporting the Commission's proposal and asserting that the persons who engage in pay to play practices know that any shortfalls would be covered by taxpayers); Bloomberg Letter ("Because the City is legally obligated to make up any short fall in the pension system assets to ensure full payment of pension benefits, pay to play practices can potentially harm all New Yorkers."). *See also* Common Cause Letter; 1997 SURVEY, *supra* note 8 ("[t]he investment of plan assets is an issue of immense consequence to plan participants, taxpayers, and to the economy as a whole" as a low rate of return will require additional funding from the sponsoring government, which "can place an additional strain on the sponsoring government and may require tax increases").

the restrictions on soliciting and coordinating contributions and payments will likely result in similar benefits to those that have resulted from MSRB rules G-37 and G-38, on which our rule is closely modeled. The MSRB rules have prohibited municipal securities dealers from participating in pay to play practices since 1994.[467] As we have stated previously, we believe these rules have significantly curbed pay to play practices in the municipal securities market, and are likely to be similarly effective in deterring pay to play activities by investment advisers.[468]

Applying the rule to government entity investments in certain pooled investment vehicles or where a pooled investment vehicle is an investment option in a government-sponsored plan or program will extend the same benefits regardless of whether an adviser subject to the rule is providing advice directly to the government entity or is managing assets for the government entity indirectly through a pooled investment vehicle. By addressing distortions in the process by which investment decisions are made regarding public investments, we are providing important protections to public pension plans and their beneficiaries, as well as participants in other important plans or programs sponsored by government entities. Other investors in a pooled investment vehicle also will be better protected from, among other things, the effects of fraud that may result from an adviser's participation in pay to play activities, such as higher advisory fees.

Finally, the amendments to rule 204-2 will benefit the public plans and their beneficiaries and participants in state plans or programs as well as investment advisers that keep the required records. The public pension plans, beneficiaries, and participants

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[467] MSRB rule G-37 was approved by the Commission and adopted by the MSRB in 1994. *See supra* note 66.

[468] *See supra* notes 101–107 and accompanying text.

will benefit from these amendments because the records required to be kept will provide Commission staff with information to review an adviser's compliance with rule 206(4)-5 and thereby may promote improved compliance. Advisers will benefit from the amendments to the recordkeeping rule as these records will assist the Commission in enforcing the rule against, for example, a competitor whose pay to play activities, if not uncovered, could adversely affect the competitive position of a compliant adviser.

B. Costs

We acknowledge that the rule and rule amendments will impose costs on advisers that provide or seek to provide advisory services to government clients directly, or indirectly through pooled investment vehicles. We discuss these costs below, along with a number of modifications we have made to the proposed rule and proposed amendments that will reduce costs.

1. Compliance Costs Related to Rule 206(4)-5

Rule 206(4)-5 requires an adviser with government clients to incur costs to monitor contributions made by the adviser and its covered associates and to establish procedures to comply with the rule. The initial and ongoing compliance costs imposed by the rule will vary significantly among firms, depending on a number of factors. Our estimated compliance costs, discussed below, take into account different ways a firm might comply with the rule. These factors include the number of covered associates of the adviser, the degree to which compliance procedures are automated (including policies and procedures that could require pre-clearance), the extent to which an adviser has a pre-existing policy under its code of ethics or compliance program,[469] and whether the

[469] One commenter stated that many investment advisers already have pay to play policies and procedures in place within the framework of their codes of ethics. *See* IAA Letter

adviser is affiliated with a broker-dealer firm that is subject to MSRB rules G-37 and G-38. A smaller adviser, for example, will likely have a small number of covered associates, and thus expend less resources to comply with the rule and rule amendments than a larger adviser.

Although a larger adviser is likely to spend more resources to comply with the rule, based on staff observations, a larger adviser is more likely to have an affiliated broker-dealer that is required to comply with MSRB rules G-37 and G-38.[470] As we learned from a broker-dealer with an investment adviser affiliate that commented on our 1999 proposal, "the more the Rule mirrors G-37, the more firms can borrow from or build upon compliance procedures already in place. . . ."[471] Accordingly, we believe

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(advocating for regulation that would address pay to play practices through an adviser's code of ethics, as an alternative to the approach taken in proposed rule 206(4)-5).

470 According to registration information available from Investment Adviser Registration Depository ("IARD") as of April 1, 2010, there are 1,332 SEC-registered investment advisers (or 11.48% of the total 11,607 registered advisers) that indicate in Item 5.D.(9) of Form ADV that they have state or municipal government clients. Of those 1,332 advisers, 113 (or 85.0%) of the largest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. 204 of the largest 20% (or 76.7%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. Conversely, only 40 (or 30.1%) of the smallest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer; and only 67 of the smallest 20% (or 25.2%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. With respect to broker-dealer affiliates, however, we note that our IARD data does not indicate whether the affiliated broker-dealer is a municipal securities dealer subject to MSRB rules G-37 and G-38. Also, as one commenter asserted, private fund managers may be among the larger advisers, based on assets under management, but they are unlikely to have an affiliated broker-dealer that has already adopted similar procedures to comply with MSRB rules G-37 and G-38 because most private fund managers are not involved in municipal underwriting. MFA Letter. We acknowledge that a private fund manager generally would be less likely to have an affiliated broker-dealer from which it can borrow or build upon compliance procedures; however, we also expect that a private fund manager would use less resources than other large registered advisers to comply with the rule because a private fund manager is not subject to rule 206(4)-7, the Advisers Act compliance rule, and would likely have fewer employees and covered associates than a larger organization.

471 Comment Letter of US Bancorp Piper Jaffray Inc. (now, "Piper Jaffray & Co.") (Nov. 15, 1999).

some advisers with broker-dealer affiliates may spend fewer resources to comply with the rule and rule amendments. We recognize, as some commenters pointed out, that MSRB rules G-37 and G-38 compliance systems may not be easily extensible in all cases, and we acknowledge that the range of efficiencies created in these circumstances will vary.[472] A prominent concern of these commenters related to a proposed recordkeeping amendment which would have required advisers to keep records of solicitations—something that is not required under MSRB recordkeeping rule G-8. As previously discussed, we are not adopting that proposed amendment, which may address the concern noted by commenters.

We anticipate that advisory firms subject to rule 206(4)-5 will develop compliance procedures to monitor the political contributions made by the adviser and its covered associates.[473] We estimate that the costs imposed by the rule will be higher initially, as firms establish and implement procedures and systems to comply with the rule and rule amendments. We expect that compliance expenses would then decline to a relatively constant amount in future years, and annual expenses are likely to be lower for small advisers as the systems and processes should be less complex than for a large adviser.

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472 SIFMA Letter. *See also* ICI Letter.

473 Investment advisers registered with the Commission are required to adopt and implement policies and procedures reasonably designed to prevent violation by the adviser or its supervised persons of the Advisers Act and the rules the Commission has adopted thereunder. *See* rule 206(4)-7.

We estimate that approximately 1,697 investment advisers registered with the Commission may be affected by the rule and rule amendments.[474] Of the 1,697 advisers, we estimate that approximately 1,271 advisers have fewer than five covered associates that would be subject to the rule (each, a "smaller firm"); approximately 304 advisers have between five and 15 covered associates (each, a "medium firm"); and approximately 122 advisers have more than 15 covered associates that would be subject to the prohibitions of the rule (each, a "larger firm").[475]

474 This estimate is based on registration information from IARD as of April 1, 2010, applying the same methodology as in the Proposing Release. As previously noted, according to responses to Item 5.D(9) of Part 1 of Form ADV, 1,332 advisers have clients that are state or municipal government entities, which represents 11.48% of all advisers registered with us. 10,275 advisers have not responded that they have clients that are state or municipal government entities. Of those, however, responses to Item 5.D(6) of Part 1 of Form ADV indicate that 2,486 advisers have some clients that are other pooled investment vehicles. Estimating that the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*,11.48%. 285 of these advisers would be subject to the rule (2,486 x 11.48 % = 285). Out of the 10,275 that have not responded that they have clients that are state or municipal government entities, after backing out the 2,486 which have clients that are other pooled investment vehicles, responses to Item 5.D(4) of Part 1 of Form ADV indicate that 699 advisers have some clients that are registered investment companies. Estimating that roughly the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*,11.48%. 80 of these advisers would be subject to the rule (699 x 11.48% = 80). Although we limited the application of rule 206(4)-5 with respect to registered investment companies to those that are investment options of a plan or program of a government entity, we continue to estimate that 80 advisers would have to comply with the recordkeeping provisions because of the difficulty in further delineating this estimated number. Therefore, we estimate that the total number of advisers subject to the rule would be: 1,332 advisers with state or municipal clients + 285 advisers with other pooled investment vehicle clients + 80 advisers with registered investment company clients = 1,697 advisers subject to rule. We expect certain additional advisers may incur compliance costs associated with rule 206(4)-5. We anticipate some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers. Additionally, some advisers that do not currently have government clients may seek to obtain them in the future. In doing so, they likely would conduct due diligence to confirm they would not be prohibited from receiving compensation for providing investment advisory services to the government client.

475 This estimate is based on registration information from IARD as of April 1, 2010. These estimates are based on IARD data, specifically the responses to Item 5.B.(1) of Form ADV, that 997 (or 74.9%) of the 1,332 registered investment advisers that have

One commenter disagreed with us basing our cost estimates on an assumption that most registered advisers would have fewer than five covered associates because the commenter expects most advisers to require all or most of their employees to receive approval prior to making any political contributions in order to avoid inadvertently triggering the rule.[476] Although the rule does not require this approach and the changes we have made to the rule (*e.g.*, modified definition of covered associate) should help address the concerns of this commenter that led to the assertion, we recognize that some advisers may voluntarily restrict all of their employees' political contributions in such a manner. This type of pre-screening process could be perceived by the individuals subject to them as costs imposed on their ability to express their support for certain candidates for elected office and government officials. We also received a comment that our estimates should take into account turnover of personnel.[477] Our cost estimate assumes a certain level of turnover; although these categories are based on an adviser's number of covered associates, we have not calculated per-covered associate costs associated with this rulemaking. The categories of smaller, medium and larger advisers are based on an estimated number of covered associates, but are not intended to represent a static population of covered associates within each category. For instance, in estimating the ongoing burdens on advisers to comply with the rule, we implicitly incorporated a greater

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government clients have fewer than five employees who perform investment advisory functions, 239 (or 17.9%) have five to 15 such employees, and 96 (or 7.2%) have more than 15 such employees. We then applied those percentages to the 1,697 advisers we believe will be subject to the proposed rule for a total of 1,271 smaller, 304 medium and 122 larger firms.

476 *See* MFA Letter.

477 ICI Letter.

degree of turnover at larger advisers in estimating that they would incur 1,000 hours annually as compared to the estimated 10 hours for a small adviser.

Advisers that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act [15 U.S.C. 80b-3(b)(3)] would be subject to rule 206(4)-5.[478] Based on our review of registration information on IARD and outside sources and reports, we estimate that there are approximately 2,000 advisers that are unregistered in reliance on section 203(b)(3).[479] Applying the same principles we used with respect to registered investment advisers, we estimate that 230 of those advisers manage pooled investment vehicles in which government client assets are invested and would therefore be subject to the rule.[480] For purposes of this analysis, it is assumed that each unregistered advisory firm that would be subject to the rule would either be a smaller firm or a medium firm in terms of number of covered associates because it is unlikely that an adviser that operates outside of public view and is limited to fewer than 15 clients[481] would have a large number of advisory personnel that would be covered associates. One commenter agreed that most of these unregistered advisers would be small, although the commenter based its assessment on assets under management, not on the adviser's likely number of covered associates.[482]

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478 The amendments to rules 204-2 and 206(4)-3, however, only apply to advisers that are registered, or required to be registered, with the Commission.

479 This number is based on our review of registration information on IARD as of April 1, 2010, IARD data from the peak of hedge fund adviser registration in 2005, and a distillation of numerous third-party sources including news organizations and industry trade groups.

480 11.48% of 2000 is 230. *See supra* note 474.

481 *See* section 203(b)(3) of the Advisers Act [15 U.S.C. 80b-3(b)(3)] (advisers who rely on this exception from registration must have fewer than 15 clients in a 12-month period) .

482 3PM Letter.

Some commenters asserted that our estimated number of advisers subject to the proposed rule was too low.[483] One claimed that the number of advisory firms exempted from registration in reliance on Section 203(b)(3) may be "over two times our estimate," but provided statistics about the number of unregistered pooled investment vehicles, not the number of advisers to those pools.[484] Other commenters did not provide empirical data or suggest alternative formulas by which to recalculate our estimate. Additionally, another seemed to misunderstand our estimates.[485]

As we stated in the Proposing Release,[486] although the time needed to comply with the rule will vary significantly from adviser to adviser, as discussed in detail below, the Commission staff estimates that firms with government clients will spend between 8 hours and 250 hours to establish policies and procedures to comply with the rule. Commission staff further estimates that ongoing compliance with the rule will require between 10 and 1,000 hours annually. In addition, advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the rule. These costs would vary widely among firms. Small advisers may not incur any system costs if they determine a system is unnecessary due to the limited number of employees they have or the limited number of government entity clients they have. Large firms likely already have devoted significant resources into automating compliance and reporting and the new rule could result in enhancements to these existing systems. We

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483 *See* Davis Polk Letter; MFA Letter; 3PM Letter.

484 3PM Letter. *See also* Davis Polk Letter (citing to 3PM Letter on this proposition).

485 Davis Polk Letter (suggesting that we failed to take into account the costs likely to be borne by unregistered investment advisers). *See supra* notes 479 and 480 and accompanying text; Proposing Release, nn.219-20 and accompanying text (providing an estimate of the number of unregistered advisers we expect to be subject to this rule, and that must develop compliance systems).

486 *See* Proposing Release, at section III.B.

believe such system costs could range from the tens of thousands of dollars for simple reporting systems, to hundreds of thousands of dollars for complex systems used by the large advisers.

Initial compliance procedures would likely be designed, and ongoing administration of them performed, by compliance managers and compliance clerks. We estimate that the hourly wage rate for compliance managers is $294, including benefits, and for compliance clerks, $59 per hour, including benefits.[487] To establish and implement adequate compliance procedures, we estimate that the rule would impose initial compliance costs of approximately $2,352 per smaller firm,[488] approximately $29,407 per medium firm,[489] and approximately $58,813 per larger firm.[490] It is

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487 Our hourly wage rate estimate for a compliance manager and compliance clerk is based on data from the *Securities Industry Financial Markets Association's Management & Professional Earnings in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 (in the case of compliance managers) or 2.93 (in the case of compliance clerks) to account for bonuses, firm size, employee benefits and overhead. The calculations discussed in this release are updated from those included in the Proposing Release to incorporate data from the most recently updated version of this publication.

488 The per firm cost estimate is based on our estimate that development of initial compliance procedures for smaller firms would take 8 hours of compliance manager time (at $294 per hour). Accordingly, the per firm cost estimate is $2,352 (8 x $294).

489 With respect to our estimated range of 8-250 hours, we assume a medium firm would take 125 hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he or she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for medium firms would take 93.75 hours of compliance manager time, at $294 per hour (or $27,563), and 31.25 hours of clerical time, at $59 per hour (or $1,844), for a total estimated cost of $29,407.

490 With respect to our estimated range of 8-250 hours, we assume a larger firm would take 250 hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he/she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for larger firms would take 187.50 hours of compliance

estimated that the rule would impose annual, ongoing compliance expenses of approximately $2,940 per smaller firm,[491] $117,625 per medium firm,[492] and $235,250 per larger firm.[493]

In establishing these estimates, which are calculated in the same manner as those we included in the Proposing Release, we took into consideration comments in 1999 that suggested our cost estimates were too low.[494] Our staff, in developing the estimates contained in the Proposing Release, also engaged in conversations with industry professionals regarding broker-dealer compliance with rules G-37 and G-38 and representatives of investment advisers that have pay to play policies in place.[495] We significantly increased our cost estimates from the 1999 proposal as a result. Some commenters on the proposed rule asserted that our projected costs are too low, but did not provide empirical data or formulas for us to review.[496] One commenter indicated that, "as a practical matter, although there may be significant differences in the number of hours dedicated to ongoing annual compliance between firms of different sizes, the

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manager time, at $294 per hour (or $55,125), and 62.5 hours of clerical time, at $59 per hour (or $3,688), for a total estimated cost of $58,813.

491 The per firm cost estimate is based on our estimate that ongoing compliance procedures for smaller firms would take 10 hours of compliance manager time, at $294 per hour, for a total estimated cost of $2,940 per year.

492 The per firm cost estimate is based on our estimate that ongoing compliance procedures for medium firms would take 375 hours of compliance manager time, at $294 per hour (or $110,250), and 125 hours of clerical time, at $59 per hour (or $7,375), for a total estimated cost of $117,625 per year.

493 The per firm cost estimate is based on our estimate that ongoing compliance procedures for larger firms would take 750 hours of compliance manager time, at $294 per hour (or $220,500) and 250 hours of clerical time, at $59 per hour (or $14,750), for a total cost of $235,250 per year.

494 *See* Proposing Release, at n.226 and accompanying text.

495 *Id.* at section III.B.

496 *See*, *e.g.*, ICI Letter; MFA Letter; SIFMA Letter.

estimated number of hours needed to develop initial compliance procedures will be similar for all firms, regardless of size. The initial effort of designing and implementing new policies and procedures and educating personnel will require similar effort and upfront fixed costs."[497] We disagree. Although there are some aspects of implementing a compliance program that would be similar among all firms regardless of their number of covered associates, we expect most costs will vary significantly among firms of different sizes as they engage in such activities as developing and monitoring reporting mechanisms to track covered associate contributions, revising their codes of ethics, training their employees, and performing routine quality control tests.

In the Proposing Release, we estimated that 75% of larger advisory firms, 50% of medium firms, and 25% of smaller firms that are subject to the rule may also engage outside legal services to assist in drafting policies and procedures, based on staff observations. In addition, we also estimated the cost associated with such an engagement would include fees for approximately three hours of outside legal review for a smaller firm, 10 hours for a medium firm, and 30 hours for a larger firm. One commenter suggested that we had underestimated both the percentage of advisers that would engage outside counsel and the number of hours that outside counsel would spend lending their assistance, but did not provide alternative estimates.[498] Based on our staff's experience administering the compliance program rule, we continue to believe that our estimates for the number of firms that will retain outside counsel for review of policies and procedures are appropriate. Based on this comment, however, we have revisited the number of hours we estimated outside counsel would spend reviewing policies and procedures and have

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497 *See* Davis Polk Letter.

498 *Id.*

increased these estimates. We now estimate the cost associated with such an engagement would include fees for approximately eight hours of outside legal review for a smaller firm, 16 hours for a medium firm, and 40 hours for a larger firm, at a rate of $400 per hour.[499] Consequently, for a smaller firm we estimate a total of $3,200 in outside legal fees for each of the estimated 318 advisers that would seek assistance, for a medium firm we estimate a total of $6,400 for the estimated 152 advisers that would seek assistance, and for each of the 92 larger firms we estimate a total of $16,000. Thus, we estimate that approximately 562 investment advisers will incur these additional costs, for a total cost of $3,462,400[500] among advisers affected by the rule amendments.[501]

One commenter suggested that, due to the complexity of, and variation among, state and local laws, it might be more difficult than we had accounted for in the proposal for an adviser to determine with certainty who could be a covered official, and as a result, a greater number of advisers would seek the help of outside counsel to make this determination than we estimated.[502] Although the commenter did not provide an estimate of how many firms might seek such assistance, we believe that the additional guidance we have provided in the discussion of officials will address this commenter's concerns and result in fewer consultations with outside counsel than anticipated. In addition, it is our understanding from discussions with those involved in advising on compliance with

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499 In the Proposing Release we estimated the hourly cost of outside counsel to be $400 based on our consultation with advisers and law firms who regularly assist them in compliance matters. We did not receive comment on this estimate and continue to believe that it is an accurate estimate.

500 (318 x $3,200 = $1,017,600) + (152 x $6,400 = $972,800) + (92 x $16,000 = $1,472,000) = $3,462,400.

501 One commenter asserted that a greater number of firms would seek assistance of counsel, regardless of size, but did not provide data to support its assertion. Davis Polk Letter.

502 Caplin & Drysdale Letter. *See also* IAA Letter; MFA Letter.

MSRB rules G-37 and G-38 that a small percentage of persons subject to the rule seek legal assistance to make these determinations. Our rule uses substantially similar definitions of "official" of a "government entity" to those used in the MSRB rules; therefore we expect that the percentage of advisory firms that would retain legal counsel to make these determinations would be similarly small. Moreover, we anticipate that the advisers that are most likely to need assistance identifying officials of government entities are larger advisers, whose businesses tend to be national in scope and whose clients are located throughout the country. If all 122 of the larger advisory firms we estimate are subject to the rule retain legal counsel at a rate of $400 per hour, for approximately 20 hours per year, those advisers would incur an estimated total of $976,000 in legal fees.[503]

In the Proposing Release, we estimated that approximately five advisers annually would apply to the Commission for an exemption from the rule, based on staff discussions with the FINRA staff responsible for reviewing exemptive applications submitted under MSRB rule G-37, and that outside counsel would spend 16 hours preparing and submitting an application. We received criticism that these approximations were too low.[504] Given that the advisory industry is much larger than the municipal securities industry, and in light of the number of comment letters we received that expressed concern about inadvertent violations of the rule that would not qualify for the exception for returned contributions, our staff estimates that approximately seven advisers annually would apply to the Commission for an exemption from the rule. Although we may initially receive more than seven applications a year for an exemption,

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503 $400 x 20 = $8,000, and $8,000 x 122 = $976,000.

504 *See* Davis Polk Letter; ICI Letter.

over time, we expect the number of applications we receive will significantly decline to an average of approximately seven annually. We continue to believe that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, but based on commenters concerns have raised the number of hours counsel will spend preparing and submitting an application from 16 hours to 32 hours, at a rate of $400 per hour.[505] As a result, each application will cost approximately $12,800, and the total estimated cost for seven applications annually will be $89,600.

2. Other Costs Related to Rule 206(4)-5

The prohibitions of the rule may also impose other costs on advisers, covered associates, third-party solicitors, and political officials.

(a) Two-Year Time Out

An adviser that becomes subject to the prohibitions of the rule would no longer be eligible to receive advisory fees from its government client. This would result in a direct loss to the adviser of revenues and profits relating to that government client, although another adviser that the government client subsequently chose to retain would see an increase in revenues and profits. The two-year time out could also limit the number of advisers able to provide services to potential government entity clients. An adviser that triggers the two-year time out may be obligated to provide (uncompensated) advisory services for a reasonable period of time until the government client finds a successor to ensure its withdrawal did not harm the client, or the contractual arrangement between the adviser and the government client might obligate the adviser to continue to perform under the contract at no fee. An adviser that provides uncompensated advisory services to a

505 The hourly cost estimate of $400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

government client would, at a minimum, incur the direct cost of providing uncompensated services, and may incur opportunity costs if the adviser is unable to pursue other business opportunities for a period of time.

Advisers to government clients, as well as covered associates of the adviser, also may be less likely to make contributions to government officials, including candidates, potentially resulting in less funding for these officials. Under the rule, advisers and covered associates will be subject to new limitations on the amounts and to whom they can contribute without triggering the rule's time out provision. In addition, these same persons will be prohibited from soliciting others to contribute or from coordinating contributions to government officials, including candidates, or payments to political parties in certain circumstances. These limitations and prohibitions, including if a firm chooses to adopt policies or procedures that are more restrictive than the rule, could be perceived by the individuals subject to them as costs imposed on their ability to express their support for certain candidates for elected office and government officials.[506] In addition to these costs, the rule's impact on advisers' and employees' contributions will introduce some inefficiency into the allocation of contributions to candidates and officials as the rule impacts contributions regardless of whether they are being made for the purpose of engaging in pay to play.

We have made several modifications to the rule from the proposal that will reduce these costs or burdens. We are creating a new exception to the two-year time out for

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506 One commenter suggested that the proposed rule would inhibit individuals who work for an investment adviser from running for office because, if they were successful, it may cost their former employer business. Caplin & Drysdale Letter. We have addressed this comment by making it clear that an individual can contribute to his or her own campaign without triggering the rule. *See supra* note 139.

contributions made by a natural person more than six months prior to becoming a covered associate unless he or she, after becoming a covered associate, solicits clients on behalf of the investment adviser.[507] This modification will decrease the burdens on both employees and employers in terms of tracking and limiting employee contributions prior to becoming employed or promoted by an investment adviser. In terms of narrowing the scope of "covered investment pools," we included a registered investment company in the definition of covered investment pool, for purposes of all three of the rule's pay to play prohibitions, only if it is an investment option of a plan or program of a government entity.[508] As noted above, we believe this approach strikes the right balance between applying the rule in those contexts in which advisers to registered investment companies are more likely to engage in pay to play conduct while recognizing the compliance challenges and costs that may result from a broader application of the rule. We are also broadening the exception to the rule's time out provision in several respects that should further decrease the compliance costs associated with the two-year time out and will lower any perceived costs on covered associates' ability to express their support for candidates. We are increasing the aggregate contribution amount eligible for the exception for certain returned contributions from $250 to $350 to any one official per election,[509] and we are increasing the number of times an adviser is permitted to rely on the returned contributions exception from two to three per calendar year for advisers with more than 50 employees.[510] Furthermore, we are making the same adjustment from $250

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507 Rule 206(4)-5(b)(2).

508 Rule 206(4)-5(f)(3) and (f)(8).

509 Rule 206(4)-5(b)(3).

510 *Id.*

to $350 for contributions eligible for the *de minimis* exception,[511] and we are adopting a *de minimis* exception for contributions not exceeding $150 made by individuals who are not entitled to vote for the candidate.[512]

Several commenters highlighted the costs of the two-year time out to the adviser and government entity client, as well as pension fund beneficiaries, stating that the time out could force termination of long-standing relationships and may result in a permanent termination of the advisory relationship.[513] We acknowledge that advisers subject to the time out may lose a government client's business beyond the two-year period and are sensitive to the concerns of commenters regarding the operation of the rule on public pension funds, including the burdens they may face in replacing managers and the possibility that some managers may no longer seek to manage public plan assets as a result of the rule. We believe that these costs are necessary to accomplish our goal of addressing pay to play and are justified by the benefits of rule 206(4)-5. As discussed above, rule 206(4)-5 is modeled on the pay to play rules adopted by the MSRB, which have significantly curbed pay to play practices in the municipal securities market. We believe that adopting a two-year time out similar to the time out applicable under the MSRB rules is appropriate, and that the fiduciary relationship advisers have with public

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511 Rule 206(4)-5(b)(1).

512 *See id.*

513 *See, e.g.*, ICI Letter ("[E]xisting state and local government clients may be harmed by the forced termination of a mutually beneficial business relationship, despite receiving free services for a period of time, because the government client is subject to the costs associated with selecting a new adviser, and plan beneficiaries are subject to the costs associated with portfolio commissions and other restructuring costs. Consequently, our members believe that the two-year ban will operate as a permanent ban because a government entity will be unlikely to go through the process of identifying and hiring a replacement adviser, and then return to the original adviser after the ban ends."). *See also* IAA Letter; NASP Letter; SIFMA Letter.

pension plans argues for a strong prophylactic rule. Finally, while we have designed the rule to reduce its impact,[514] investment advisers are best positioned to protect government clients by developing and enforcing robust compliance programs designed to prevent contributions from triggering the two-year time out.

Commenters also noted, particularly, the potential harm of the two-year time out to government clients and to other investors in a fund that holds illiquid securities when a government investor redeems its interests in the fund as a result of the fund adviser's triggering contribution.[515] As we note above, however, our rule does not require an adviser that has triggered the time out to redeem the interests of a government investor or cancel its commitment. The adviser may have multiple options available from which to select to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. The adviser could instead comply with the rule by waiving or rebating the portion of its fees or any performance allocation or carried interest attributable to the government client.[516]

Most of the comments we received about the costs of this aspect of the proposed rule, however, focused on the costs of an inadvertent violation.[517] We understand that there will be costs, sometimes quite significant, as a result of inadvertent violations. However, with these potential costs in mind, we have taken additional steps to decrease

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514 *See, e.g.*, section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to the two-year time out); section II.B.2(f) of this Release (discussing the rule's exemptive provision).

515 CT Treasurer Letter; NY City Bar Letter.

516 *See supra* note 385 and accompanying text.

517 *See, e.g.*, IAA Letter ("We are concerned that the Commission has not considered the significance of the sanctions imposed as a result of an adviser's inadvertent violation of the rule.").

the likelihood of inadvertent violations of the rule. First, as discussed above, we shortened the look back with respect to most covered associates. We expect this new exception will provide an additional mechanism for advisers to avoid the cost of a time out as a result of an inadvertent violation and will largely address commenters' concerns about the screening burdens for new or promoted employees that this aspect of the proposal would have imposed on advisers.[518] Second, as discussed above, we are increasing to $350 the amount eligible for an exception for certain returned contributions from what we had proposed, we are increasing the number of times an adviser is permitted to rely on the returned contributions exception, and we are also adopting an additional *de minimis* exception for certain contributions not exceeding $150. Last, we note that an adviser's implementation of a strong compliance program will reduce the likelihood, and therefore costs, of inadvertent violations.

One commenter asserted that the proposed rule would put advisers at a competitive disadvantage to other providers of advisory services to government plans that would not be subject to it, such as banks and insurance companies.[519] As we stated earlier, we believe that the concerns that we are trying to address with the rule justify its adoption, notwithstanding the potential competitive effects that advisers may face as a

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518 IAA Letter ("Under the Proposal, investment advisers would be required to screen for and eliminate potential employment candidates based upon contributions made for a period of up to twenty-four months before the person would begin employment with the adviser. This requirement . . . would be extremely costly and burdensome to implement."); Wells Fargo Letter ("The "look back" provision is too draconian. . . . [A] compliance system [will be] costly to develop and arduous to implement . . . [and] it would also impose severe limitations on the career opportunities of those newly entering the investment advisory world who are weighed down by political contributions that were completely innocuous when made.").

519 NY City Bar Letter.

result of the limits on our jurisdiction. We also do not view competition by means of engaging in practices such as pay to play as an interest that we need to protect.

(b) Third-Party Solicitor Ban

Under our proposal, advisers would have been prohibited from compensating any third party to solicit government entities for advisory services, other than "related persons."[520] As a result, advisers that rely on third-party solicitors to obtain government clients would have had to bear the expense of hiring and training in-house staff in order to continue their solicitation activities,[521] a result that commenters said would be particularly costly for small and new investment advisers.[522] In addition, third-party solicitors might also have experienced substantial negative consequences under the

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520 Proposed rule 206(4)-5(a)(2)(i)(a).

521 *See, e.g.*, Comment Letter of Greenhill & Co., LLC (Oct. 2, 2009) ("The elimination of placement agents would add a significant administrative and cost burden to fund sponsors seeking investors."). *See also* Alta Letter; Atlantic-Pacific Letter; Braxton Letter; Benedetto Letter; CA Assoc. of County Retirement Letter; Capstone Letter; EVCA Letter; GA Firefighters Letter; Glovista Letter; IL Fund Association Letter; MN Board Letter; Myers Letter; NCPERS Letter; NYC Teachers Letter; PA Public School Retirement Letter; Reed Letter; Myers Letter; TX Public Retirement Letter; WI Board Letter; Credit Suisse Letter ("Moreover, by performing these functions, placement agents enable investment advisers to focus on their core expertise, investment management, and to avoid the necessity of developing the costly in-house resources necessary to raise capital directly.").

522 *See, e.g.*, MFA Letter ("[M]anagers that engage placement agents, particularly small and offshore managers, would lose the ability to market their services to government clients or incur significantly higher costs to hire internal marketing personnel; and managers that hire internal personnel could spend substantial amounts to register as a broker-dealer."). *See also* SIFMA Letter; IAA Letter; Seward & Kissel Letter; Sadis & Goldberg Letter; WI Board Letter; GA Firefighters Letter; MN Board Letter; IL Fund Association Letter; NYC Teachers Letter; TX Public Retirement Letter; PA Public School Retirement Letter; Ehrmann Letter; Finn Letter; Savanna Letter; Atlantic-Pacific Letter; Peterson Letter; Devon Letter; Chaldon Letter; Meridian Letter; Benedetto Letter; Capstone Letter; Braxton Letter; Littlejohn Letter; Alta Letter; Charles River Letter; Reed Letter; Glovista Letter; Blackstone Letter; Park Hill Letter.

proposed rule.[523] We heard from many commenters on this issue, offering various perspectives on how the costs would outweigh the benefits of the proposed prohibition.[524] A few commenters asserted that this proposal would have a significant adverse effect on efficient capital formation in that it would make it more difficult for private equity and venture capital managers to obtain funding that they in turn can invest in portfolio companies.[525] As other commenters pointed out, this aspect of our proposed rule might also have placed a significant burden on public pension plans,[526] particularly smaller

523 Proposing Release, at 89. *See also* Thomas Letter ("The ban would very likely cripple many legitimate placement agents – most of whom are currently regulated by the SEC and FINRA – as the public pension plans are the largest source of capital for alternative investments."); Comment Letter of the Managing Partner of Bridge 1 Advisors, LLC Robert G. McGroarty (Sept. 24, 2009) ("Bridge 1 Letter"); SIFMA Letter.

524 *See, e.g.*, Davis Polk Letter ("While we strongly support the underlying purpose of the Proposed Rule, we believe that this ban on all third-party solicitors is overly expansive and the costs inflicted on both investment advisers and government clients from lack of access to the valuable services provided by most third-party solicitors outweigh any expected benefits to be gained from its adoption."); Capstone Letter (suggesting that many placement agent firms are small businesses helping investment managers that are, themselves, minority- or women-owned small businesses, and that, together, they are creating jobs and helping other businesses by efficiently directing capital); Monument Letter (making a similar comment regarding the minority and female ownership of placement agents); Glantz Letter; Comment Letter of Indian Harbor Partner Robert W. Stone (Aug. 13, 2009) ("Indian Harbor Letter"); Kurmanaliyeva Letter; M Advisory Letter (adding that the investment management industry as a whole will incur "dramatic job losses"); Parenteau Letter.

525 Alta Letter; Benedetto Letter; Comment Letter of Berkshire Property Advisors, LLC (Sept. 29, 2009) ("Berkshire Letter"); Bridge 1 Letter; Comment Letter of Hampshire Real Estate Companies (Sept. 29, 2009); Comment Letter of Thomas J. Mizo on behalf of HFF Securities L.P. (Sept. 24, 2009); M Advisory Letter; Monument Group Letter; Comment Letter of Psilos Group Managers, LLC (Sept. 28, 2009).

526 *See, e.g.*, Park Hill Letter ("The Commission has commented that if the Placement Agent Ban is adopted, Public Pension Investors can seek to engage placement agents themselves in order to continue to have access to their services in helping to find the best Fund Sponsors. However, that would impose costs on Public Pension Investors that they do not currently incur. Moreover, as the Commission has acknowledged in its cost-benefit analysis, if the Placement Agent Ban were adopted, Fund Sponsors who do not have in-house marketing staffs would be disproportionately disadvantaged relative to larger firms that have those internal resources in the competition for obtaining access to Public Pension Investors and other institutional investors."); Thomas Letter ("A ban on placement agents would have significant unintended consequences for public pension

plans because third-party solicitors provide services that plans may value, including serving as placement agent for alternative investments and serving a screening function with respect to those investments presented to the pension plan.[527]

Others argued, for similar reasons as those expressed above, that it would also harm public pension plans to ban payments to third parties because it would decrease

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plans. . . . [For instance, the] incremental effort by investment staffs to perform due diligence on promising but possibly ill-prepared investment managers will raise the cost and lessen the overall pension fund portfolio performance."); Comment Letter of Austin F. Whitman (Sept. 21, 2009) ("Without access to placement agents, government pensions would be significantly disadvantaged relative to their private sector peers, with limited access (and benefit from) the services described above."); ABA Letter. *But see* Fund Democracy/Consumer Federation Letter ("The proposed ban would simply replace the indirect cost of placement agents incurred by pension plan sponsors with the direct cost of hiring their own placement agents – without the conflict of interest and potential for abuse that relying on advisers' placement agents creates.").

527 *See, e.g.*, Ogburn Letter; Schmitz Letter (highlighting the valuable "pre-vetting" function of placement agents, especially in light of pension funds' budgetary pressures and lean staffs); Savanna Letter (discussing the "pre-screening" effect that reputable placement agent client selection provides for pension professionals); Atlantic-Pacific Letter; Indian Harbor Letter; Peterson Letter; Rubenstein Letter; Comment Letter of Réal Desrochers (Aug. 20, 2009) (noting that from the perspective of a former pension fund investment officer, "[t]he skill sets of certain placement agents streamlined what they brought to our attention and made our internal process much more efficient."); Devon Letter; Thomas Letter; Myers Letter; PRIM Board Letter ("[T]he Commission should strongly resist the politically expedient suggestion that an outright ban on the use of placement agents is somehow good for plan sponsors; nothing could be further than the truth."); Meridian Letter; Comment Letter of Norman G. Benedict (Sept. 30, 2009) (indicating that, from the perspective of a retired public pension chief investment officer, placement agents provide an essential and invaluable service, particularly with providing access to private equity fund investments, which often yielded higher returns than more traditional, publicly traded securities); Berkshire Letter; Comment Letter of The British Private Equity and Venture Capital Association (Sept. 18, 2009) ("BVCA Letter") ("Placement agents are not just a crude middleman in the fundraising process"); CT Treasurer Letter; Credit Suisse Letter (describing four key functions its placement agent group performs); Portfolio Advisors Letter (noting that among the valuable services provided are: "(1) helping new fund sponsors to become more established among the institutional investor community; (ii) helping sponsors to complete RFPs, provide information and respond to questions, which, in turn, gives the public pension plans and other investors a broader pool of investment options; and (iii) serving as intermediaries in uniting capital with fund sponsors who can put the money to work by investing in businesses and creating value"); George Letter; Comment Letter of Rahul Mehta (Sept. 11, 2009); Touchstone Letter; SIFMA Letter.

competition by reducing the number of advisers competing for government business[528] and limit the universe of investment opportunities presented to public pension funds.[529]

We believe our decision to modify the proposed rule to permit advisers to make payments to certain "regulated persons" to solicit government clients on their behalf,[530] as described in more detail above, should alleviate many of these concerns, including those from private equity and venture capital managers on capital formation.[531] In particular, we believe the concerns expressed by private equity and venture capital managers regarding the effects of the rule on capital formation have been substantially addressed by the modification for payments to "regulated persons." We expect advisers that engage the services of regulated person solicitors will incur limited costs to initially confirm and subsequently monitor the solicitor's eligibility to be a "regulated person." Nevertheless, we expect this exception to the third-party solicitor ban will substantially reduce the costs commenters associated with this aspect of the proposal.

We acknowledge, however, that the third-party solicitor ban will nonetheless have a substantial negative impact on persons who provide third-party solicitation services that

528 *See, e.g.*, Seward & Kissel Letter; Meridian Letter; SIFMA Letter; Comment Letter of Oakpoint Advisors (Aug. 26, 2009); Comment Letter of SeaCrest Investment Management, LLC (Sept. 25, 2009).

529 *See, e.g.*, Braxton Letter (stressing not only the increased costs that public pension funds will likely face, but also the likely reduction in creative investment strategies and opportunities available as a result of smaller and emerging funds being forced out of the market); BVCA Letter; CT Treasurer Letter; SIFMA Letter; IAA Letter; Strategic Capital Letter; Alta Letter; Benedetto Letter; Glantz Letter; Kurmanaliyeva Letter; Park Hill Letter.

530 *See* Rule 206(4)-5(a)(2)(i).

531 Our decision not to adopt the "related person" exception contained in the proposed rule does not diminish our belief. As we noted above, we believe our modification of the ban to allow advisers to pay "regulated persons" to solicit government entities on their behalf will still allow advisers to use employees of certain related companies—*i.e.*, of those related companies that qualify as "regulated persons"—as solicitors.

are not regulated persons, including state-registered advisers.[532] If their businesses consist solely of soliciting government entities on behalf of investment advisers, the rule could result in these persons instead being employed directly by regulated persons, shifting the focus of their solicitation activities, seeking to change their business model to shift their source of payment from investment advisers to pension plans, or going out of business.[533] In addition, we acknowledge that the third-party solicitor ban may adversely affect both competition and allocative efficiency in the market for advisory services where third-party solicitors that are not regulated persons participate. We have carefully considered these effects. As discussed above, however, we do not have regulatory authority to oversee the activities of state-registered advisers through examination and our recordkeeping rules. Nor do we have authority over the states to oversee their enforcement of their rules, as we do with FINRA. As a result, we have not included state-registered advisers in the definition of regulated person.[534]

In addition, some commenters suggested that the third-party prohibition could have a negative impact on the efficient allocation of capital for government plans, particularly small ones, and advisers that seek to manage these assets directly (not through a covered investment pool).[535] These small government plans may, as a result of the rule's ban on payments to third parties, have fewer managers to select from to the extent that larger advisers choose not to participate in this market. In addition, both government plans and advisers that seek these government clients may have to hire

532 As we note above, state-registered advisers are subject neither to our oversight nor to the recordkeeping rules we are adopting today.

533 *See supra* note 523.

534 *See supra* note 325 and accompanying text.

535 *See, e.g.*, 3PM Letter; Bryant Law Letter.

internal staff, respectively, to identify potential advisers and potential government clients to the extent these functions are not internalized. However, these commenters did not discuss the potentially significant costs that exist today of hiring third-party solicitors, and that eliminating the cost of pay to play may, in fact, provide greater access to pension plans by those advisers that are currently unable to afford the costs of direct or indirect political contributions or third-party solicitor fees.[536] We expect that prohibiting pay to play will reduce the costs to plans and their beneficiaries that may result when adviser selection is based on political contributions rather than investment considerations.[537]

3. Costs Related to the Amendments to Rule 204-2

The amendments to rule 204-2 require SEC-registered advisers with government clients to maintain certain records of campaign contributions by certain advisory personnel and records of the regulated persons the adviser pays or agrees to pay to solicit government entities on its behalf.[538] Records are a critical complement to rule 206(4)-5. In particular, such records are necessary for examiners to inspect advisers for compliance with the terms of the rule.

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536 At least one commenter agreed. *See* Butler Letter ("[W]e find some evidence that the pay to play practices by underwriters [before rule G-37 was adopted] distorted not only the fees, but which firms were allocated business. The current proposal mentions that pay to play practices may create an uneven playing field among investment advisers by hurting smaller advisers that cannot afford to make political contributions. We find evidence that is consistent with this view [in our research on pay to play by municipal underwriters]. During the pay to play era, municipal bonds were underwritten by investment banks with larger underwriting market shares compared to afterward. One interpretation of this result is that smaller underwriters were passed over in favor of larger underwriters (who presumably had deeper pockets for political contributions).").

537 *See supra* notes 452 & 453 and accompanying text (describing commenters' observations about some of the pay to play costs to plans and their beneficiaries).

538 Unregistered advisers that would be subject to rule 206(4)-5 would not be subject to the amendments to rule 204-2.

As described below, for purposes of the Paperwork Reduction Act of 1995 ("PRA"),[539] we have estimated that Commission-registered advisers would incur approximately 3,394 additional hours annually to comply with the amendments to rule 204-2.[540] Based on this estimate, we anticipate that advisers would incur an aggregate cost of approximately $200,246 per year for the total hours advisory personnel would spend in complying with the recordkeeping requirements.[541] In addition, we expect advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the amendments to rule 204-2. For purposes of the PRA, we have estimated that some small and medium firms will incur start-up costs, on average, of $10,000, and larger firms will incur, on average, $100,000. As a result, the amendments to rule 204-2 are estimated to increase the PRA non-labor cost burden by $20,080,000.[542]

We received a number of specific comments on this aspect of the proposal, many of which included assertions about cost burdens associated with maintaining records related to unsuccessful solicitations, and urged us to reconsider the benefits to be gained from such a requirement in light of the costs.[543] We were persuaded by these

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539 44 U.S.C. 3501.

540 *See infra* note 559 and accompanying text.

541 We expect that the function of recording and maintaining records of political contributions would be performed by a compliance clerk at a cost of $59 per hour. *See supra* note 487. Therefore, the total costs would be $200,246 (3,394 hours x $59 per/hour).

542 ($10,000 x 788) + ($100,000 x 122) = $7,880,000 + $12,200,000 = $20,080,000.

543 MassMutual Letter ("[T]he requirement to maintain records of each governmental entity being solicited would require a diverse financial services company like MassMutual to undertake significant legacy software system modifications or build an entirely new system to track each instance of a "solicitation," which could include phone calls, meetings, or responses to governmental requests. This system would then need to aggregate data across multiple business lines, many with existing systems that may not have the ability to share this data in a useful format. All of these are costly and time consuming activities to meet a requirement that appears to add little value to the

commenters to eliminate provisions of the proposed amendments to the recordkeeping rule that would have required advisers to maintain a list of government entities that the adviser solicits.[544] Instead, an adviser must only retain records of existing government entity clients and investors as well as records of regulated persons that the adviser pays or agrees to pay to solicit government entities on its behalf for a five-year period. Additionally, we have narrowed the scope of the amended rule to apply only to advisers with government entity clients; an adviser is only required to make and keep these records if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services.[545] We have also limited the rule to provide that only records of contributions, not payments, to government officials and candidates are required to be kept under the rule. Additionally, because rule 206(4)-5 applies to an adviser to a registered investment company only if it is an investment option of a participant-directed plan or program of a government entity,[546] such investment advisers will only have to identify government entities that provide plan or program participants the option of investing in the fund, which addresses many commenters' concerns about recordkeeping burdens that would have been imposed on advisers to registered investment companies under the proposed rule.[547]

Commission's efforts to ensure compliance with the Proposed Rule."). *See also* Davis Polk Letter; Dechert Letter; Holl Letter; SIFMA Letter; Skadden Letter.

544 *See* proposed rule 204-2(a)(18)(i)(B).

545 Rule 204-2(a)(18)(iii). *See* NASP Letter ("Many advisers do not have governmental clients but will still have to collect the information or attestations which would increase compliance costs while providing no public benefit at all.")

546 *See supra* note 353 and accompanying text.

547 *See, e.g.*, ICI Letter.

We anticipate that commenters' general concerns that we may have underestimated the burdens we presented in our proposal will be offset by what we believe will be a reduction in burdens as a result of the various modifications from our proposal described above. In addition, we have revised the rule to require advisers to maintain a list of regulated persons that solicit on an adviser's behalf, but expect advisers to already have this information in the normal course of business, including in some instances, to comply with existing requirements of rule 206(4)-3.

V. PAPERWORK REDUCTION ACT

A. Rule 204-2

The amendment to rule 204-2 contains a "collection of information" requirement within the meaning of the PRA. In the Proposing Release, the Commission solicited comment on the proposed amendment to the collection of information requirement.[548] The Commission also submitted the proposed amendment's collection of information requirement to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under control number 3235-0278. The title for the collection of information is "Rule 204-2 under the Investment Advisers Act of 1940." Rule 204-2 contains a currently approved collection of information number under OMB control number 3235-0278. An agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 204 of the Advisers Act provides that investment advisers registered or required to be registered with the Commission must make and keep certain records for

548 *See* Proposing Release, at section IV.

prescribed periods, and make and disseminate certain reports. Rule 204-2 sets forth the requirements for maintaining and preserving specified books and records. This collection of information is mandatory. The collection of information under rule 204-2 is necessary for the Commission staff to use in its examination and oversight program, and the information generally is kept confidential.[549] The respondents are investment advisers registered or required to be registered with us.

Today's amendments to rule 204-2 require every investment adviser registered or required to be registered that provides advisory services to (or pays or agrees to pay regulated persons to solicit) government entities to maintain certain records of contributions made by the adviser or any of its covered associates and regarding regulated persons the adviser pays or agrees to pay for soliciting government entities on its behalf. The amendments require such an adviser to make and keep the following records: (i) the names, titles, and business and residence addresses of all covered associates of the investment adviser; (ii) all government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years, but not prior to the effective date of the rule; (iii) all direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or payments to a political party of a state or political subdivision thereof, or to a political action committee; and (iv) the name and business address of each regulated person to whom the investment adviser provides or agrees to provide, directly or indirectly,

549 *See* section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

payment to solicit a government entity for investment advisory services on its behalf, in accordance with rule 206(4)-5(a)(2)(i).

The adviser's records of contributions and payments are required to be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment, and whether such contribution or payment was subject to the exception for certain returned contributions pursuant to rule 206(4)-5(b)(2). An investment adviser is only required to make and keep current the records referred to in (i) and (iii) above if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the adviser provides investment advisory services. The records required by amended rule 204-2 are required to be maintained in the same manner, and for the same period of time, as other books and records under rule 204-2(a). This collection of information will be found at 17 CFR 275.204-2. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act are not subject to the recordkeeping requirements.

The amendments to rule 204-2 that we are adopting today differ from our proposed amendments in several respects. We have tailored certain of the requirements from our proposal. First, we have limited the rule to provide that only records of contributions, not payments, to government officials, including candidates, are required to be kept under the rule. Second, investment advisers to registered investment companies only have to identify—and keep records regarding—government entities that invest in a fund as part of a plan or program of a government entity, including any government entity that selects the fund as an investment option for participants in the plan or program.[550] Third, we are not adopting provisions of the proposed amendments to the recordkeeping rule that would have required advisers to maintain a list of all government entities that they have solicited. In addition, we have revised the rule so that only those advisers that have government entity clients must make and keep certain required records, unlike the proposal, which would have required all registered advisers to maintain records of contributions and covered associates. We are also adopting a requirement that advisers maintain records of regulated persons they pay to solicit government entities on their behalf, to reflect that rule 206(4)-5 permits advisers to compensate these solicitors.

As noted above, we requested comment on the PRA analysis contained in the Proposing Release. Although a few commenters expressed general concerns that the paperwork burdens associated with our proposed amendments to rule 204-2 might be understated, commenters representing advisers to registered investment companies suggested that the proposal significantly underestimated the burden attributed to these covered investment pools.[551] With respect to registered investment companies, commenters noted that the proposed recordkeeping requirements required advisers to identify government investors in registered investment companies regardless of whether the fund was part of a plan or program of a government entity, and as a result the

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550 Under our proposal, investment advisers to registered investment companies would have had to identify and keep records regarding government entities that invest in the funds regardless of whether they were part of a plan or program of a government entity. For a discussion of this modification, see section II.B. of this Release.

551 *See* ICI Letter ("[I]n relying on the estimates for compliance with the MSRB rules, the Commission significantly underestimates the compliance and recordkeeping burdens associated with the proposed rule.").

proposed amendments to the recordkeeping rule would have been difficult to comply with as fund shareholder records do not necessarily identify government investors.

As a result of these comments, we recognize that we may have underestimated the recordkeeping burden for advisers to registered investment companies that would have been subject to proposed rule 206(4)-5. However, we believe that our change to the definition of "covered investment pool" from the proposal to only include those registered investment companies that are an investment option of a plan or program of a government entity addresses the recordkeeping concerns commenters expressed regarding these covered investment pools and lowers recordkeeping burdens by limiting the records relating to registered investment companies that an investment adviser must keep under the rule.[552] In addition, the other changes we highlight above—other than the requirement to keep records regarding regulated persons—would lessen the recordkeeping requirements relative to our proposal and thereby diminish our burden estimates. We anticipate that commenters' general concerns that we may have underestimated the burdens we presented in our proposal, as well as the burden associated with the additional requirement to maintain a list of regulated persons that solicit on an adviser's behalf, will be offset by what we believe will be a reduction in burdens as a result of the various modifications from proposed amendments to the recordkeeping rule, as described above. Moreover, notwithstanding the fact that the amendments we are adopting reduce advisers' recordkeeping obligations relative to our proposal, we are increasing our estimates to address the additional investment advisers who have registered with us since our proposal was issued.

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552 *See* Rule 204-2(a)(18)(i)(B).

Prior to today's amendments, the approved collection of information for rule 204-2, set to expire on March 31, 2011, was based on an average of 181.15 burden hours each year, per Commission-registered adviser, for a total of 1,954,109 burden hours. In addition, the currently-approved collection of information for Rule 204-2 includes a non-labor cost estimate of $13,551,390. The total burden is based on an estimate of 10,787 registered advisers.

Commission records indicate that currently there are approximately 11,607 registered investment advisers subject to the collection of information imposed by rule 204-2.[553] As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 148,543 hours.[554] In addition, the total non-labor cost burden has increased to $14,581,509 as a result of this increase in the number of registered advisers.[555]

In our Proposing Release, we estimated that approximately 1,764 Commission-registered advisers provide, or seek to provide, advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.[556] One commenter argued that this estimate was too low because it underestimates the number of investment advisers unregistered in reliance on Section 203(b)(3) of the Advisers Act and estimated to be subject to the

553 This figure is based on registration information from IARD as of April 1, 2010. The figures we relied on in our Proposing Release were based on registration information from IARD as of July 1, 2009. *See* Proposing Release, at section IV.

554 11,607 – 10,787 = 820. 820 additional advisers x 181.15 hours = 148,543 hours.

555 We estimate that non-labor costs attributed to rule 204-2 will increase in the same proportion as the increase in the estimated hour burden for the rule. (2,102,652 hours /1,954,109 hours) x $13,551,390 currently approved non-labor cost estimate = $14,581,509.

556 *See* Proposing Release, at section IV.

Proposed Rule.[557] Unregistered advisers are not subject to rule 204-2's recordkeeping requirements. As a result, they are not included in our estimates for purposes of this analysis. We continue to believe our estimates are appropriate, although we have revised this number for purposes of both our cost-benefit analysis above and our PRA analysis to reflect both an increase in the number of registered advisers since the proposal and the modification from our proposal to not require records of unsuccessful solicitations. We now estimate that approximately 1,697 registered advisers provide advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.[558]

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557 Davis Polk Letter ("The cost benefit analysis is based solely on an estimated 1,764 registered investment advisers and does not account for the costs and burdens of compliance attributable to investment advisers exempt from registration. The estimated number of investment advisers unregistered in reliance on section 203(b)(3) of the Advisers Act (2,000) and estimated to be subject to the Proposed Rule (231), appears to be low. In its comment letter, the Third Party Marketers Association notes that the number of advisory firms exempted from registration may be 'over two times the estimate of the Commission. . . .'" (citations omitted)). The Davis Polk Letter does not offer any of its own estimates for the number of unregistered advisers, and the 3PM Letter references statistics regarding the number of funds, not the number of advisers.

558 This estimate is based on registration information from IARD as of April 1, 2010, applying the same methodology as in the Proposing Release. As previously noted, according to responses to Item 5.D(9) of Part 1 of Form ADV, 1,332 advisers have clients that are state or municipal government entities, which represents 11.48% of all advisers registered with us. 10,275 advisers have not responded that they have clients that are state or municipal government entities. Of those, however, responses to Item 5.D(6) of Part 1 of Form ADV indicate that 2,486 advisers have some clients that are other pooled investment vehicles. Estimating that the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*,11.48%. 285 of these advisers would be subject to the rule (2,486 x 11.48 % = 285). Out of the 10,275 that have not responded that they have clients that are state or municipal government entities, after backing out the 2,486 which have clients that are other pooled investment vehicles, responses to Item 5.D(4) of Part 1 of Form ADV indicate that 699 advisers have some clients that are registered investment companies. Estimating that roughly the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*,11.48%. 80 of these advisers would be subject to the rule (699 x 11.48% = 80). Although we limited the application of rule 206(4)-5 with respect to registered investment companies to those that are investment options of a plan or program of a government entity, we continue to estimate that 80 advisers would have to comply with

Under the amendments, each respondent is required to retain the records in the same manner and for the same period of time as currently required under rule 204-2. The amendments to rule 204-2 are estimated to increase the burden by approximately 2 hours per Commission-registered adviser with government clients annually for a total increase of 3,394 hours.[559] The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 204-2 thus would be 2,106,046 hours.[560] The revised average burden per Commission-registered adviser would be 181.45 hours.[561]

Additionally, as we noted in the Proposing Release and reiterate above, we expect advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the amendments to rule 204-2. These costs would vary widely among firms. Small advisers may not incur any system costs if they determine a system is unnecessary due to the limited number of employees they have or the limited number of government entity clients they have. Large firms likely already have devoted

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the recordkeeping provisions because of the difficulty in further delineating this estimated number. Therefore, we estimate that the total number of advisers subject to the rule would be: 1,332 advisers with state or municipal clients + 285 advisers with other pooled investment vehicle clients + 80 advisers with registered investment company clients = 1,697 advisers subject to rule. We expect certain additional advisers may incur compliance costs associated with rule 206(4)-5. We anticipate some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers. In the Proposing Release, our estimates included an estimated burden attributable to advisers that do not currently have government clients but that may begin to seek them. The revision to the recordkeeping rule that eliminated the requirement to maintain records of government entities that an adviser solicits has eliminated the need for this additional burden estimate.

559 2 x 1,697 = 3,394.

560 1,954,109 (current approved burden) + 148,543 (burden for additional registrants) + 3,394 (burden for proposed amendments) = 2,106,046 hours.

561 2,106,046 (revised annual aggregate burden) divided by 11,607 (total number of registrants) = 181.45.

significant resources into automating compliance and reporting and the new rule could result in enhancements to these existing systems.

As a result of these one-time costs, we estimate that there will be an increase to the total non-labor cost burden. We estimated above that the non-labor cost burden has increased to $14,581,509 as a result of the increase in the number of registered advisers since the collection was last approved.[562] We believe the one-time costs could vary substantially among smaller, medium, and larger firms as smaller and medium firms may be able to use non-specialized software, such as a spreadsheet, or off-the-shelf compliance software to keep track of the information required by the rule while larger firms are more likely to have proprietary systems. Based on IARD data we estimate that there are approximately 1,271 smaller firms, 304 medium firms, and 122 larger firms.[563] We estimate that one half of the smaller and medium firms will not incur these one-time start up costs because they will use existing tools for compliance. We expect the other half of smaller and medium firms will incur one-time start up costs on average of $10,000, in the event they have a greater number of employees and government clients, and larger firms, that likely have the most employees and government clients, will incur one-time start up costs on average of $100,000. As a result, the amendments to rule 204-

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562 *See supra* note 555.

563 This estimate is based on registration information from IARD as of April 1, 2010. These estimates are based on IARD data, specifically the responses to Item 5.B.(1) of Form ADV, that 997 (or 74.9%) of the 1,332 registered investment advisers that have government clients have fewer than five employees who perform investment advisory functions, 239 (or 17.9%) have five to 15 such employees, and 96 (or 7.2%) have more than 15 such employees. We then applied those percentages to the 1,697 advisers we believe will be subject to the proposed rule for a total of 1,271 smaller, 304 medium and 122 larger firms.

2 are estimated to increase the non-labor cost burden by $20,080,000.[564] Due to this increase, we now estimate the revised total non-labor cost burden for rule 204-2 to be $34,661,509.

B. Rule 206(4)-3

The amendment to rule 206(4)-3 contains a revised collection of information requirement within the meaning of the PRA. In the Proposing Release, the Commission published notice soliciting comment on the collection of information requirement.[565] The Commission submitted the revised collection of information requirement to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. Rule 206(4)-3 contains a currently approved collection of information under OMB control number 3235-0242. The title for the collection of information is "Rule 206(4)-3 – Cash Payments for Client Solicitations." As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 206(4) of the Advisers Act provides that it shall be unlawful for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)-3 generally prohibits investment advisers from paying cash fees to solicitors for client referrals unless certain conditions are met. The rule requires that an adviser pay all solicitors' fees pursuant to a written agreement that the adviser is required to retain. This collection of information is

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564 [$10,000 x 788] + [$100,000 x 122] = $7,880,000 + $12,200,000 = $20,080,000.

565 *See* Proposing Release, at section IV.

mandatory. The Commission staff uses this collection of information in its examination and oversight program, and the information generally is kept confidential.[566]

The Commission is adopting amendments to rule 206(4)-3 under the Advisers Act. The amendments to rule 206(4)-3, which are identical to our proposed amendments, require every investment adviser that relies on the rule and that provides or seeks to provide advisory services to government entities to also abide by the limitations provided in rule 206(4)-5. This collection of information is found at 17 CFR 275.206(4)-3. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act would not be subject to rule 206(4)-3.

We requested comment on the PRA analysis contained in Proposing Release. We received no comment on this portion of our analysis. In addition, we have not modified our amendments to rule 206(4)-3 relative to our proposal.

The current approved collection of information for rule 206(4)-3, set to expire on March 31, 2011, is based on an estimate that 20 percent of the 10,817 Commission-registered advisers (or 2,163 advisers) rely on the rule, at an average of 7.04 burden hours each year, per respondent, for a total of 15,228 burden hours (7.04 x 2,163).

Commission records indicate that currently there are approximately 11,607 registered investment advisers,[567] 20 percent of which (or 2,321) are likely subject to the collection of information imposed by rule 206(4)-3. As a result of the increase in the number of advisers registered with the Commission since the current total burden was

566 Section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

567 This figure is based on registration information from IARD as of April 1, 2010. The figures we relied on in our Proposing Release were based on registration information from IARD as of July 1, 2009.

approved, the total burden has increased by 1,112.32 hours (158 additional advisers[568] x 7.04 hours). We estimate that approximately 20 percent of the Commission-registered advisers that use rule 206(4)-3 (or 464 advisers)[569] provide, or seek to provide, advisory services to government clients.[570] Under the amendments, each respondent would be prohibited from certain solicitation activities, subject to the exception for "regulated persons," with respect to government clients, activities that otherwise would have been covered by rule 206(4)-3.[571] Thus, they would not need to enter into and retain the written agreement required under rule 206(4)-3 with respect to those third parties they are prohibited from paying to solicit government entities.

In the Proposing Release, we estimated a decrease to the burden due to the prohibition on paying third party solicitors to be 20% of the annual burden. As a result of the revised ban on using third parties, we now estimate that the amendments to rule 206(4)-3 will only decrease the burden by 15 percent,[572] or approximately 1.06 hour,[573] per Commission-registered adviser that uses the rule and has or is seeking government

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568 2,321 (20% of current registered investment advisers) – 2,163 (20% of registered investment advisers when burden estimate was last approved by OMB) = 158.

569 2,321 x 20 percent = 464.

570 In light of the 11.48% of registered investment advisers that indicate they have state or municipal government clients, we conservatively estimate that 20% of the advisers who rely on rule 206(4)-3 are soliciting government entities to be advisory clients or to invest in covered investment pools those advisers manage. *See supra* note 558.

571 Rule 206(4)-3(a).

572 In our proposal, which would have banned the use of third-party solicitors altogether, we estimated a 20 percent decrease in the burden under rule 206(4)-3. But, to account for the regulated persons exception to the third-party solicitor ban in adopted rule 206(4)-5, we have modified our estimate to only a 15 percent decrease. That is because our staff estimates that one quarter (or 5 percent) of the proposal's estimated burden reduction relating to entering into and retaining the written agreement required under rule 206(4)-3 will be retained as investment advisers engage third parties that are regulated persons to solicit on their behalf.

573 7.04 x 15 percent = 1.06.

clients annually, for a total decrease of 491.84 hours.[574] The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 206(4)-3 thus would be 15,848.48 hours.[575] The revised average burden per Commission-registered adviser would be 6.83 hours.[576]

C. Rule 206(4)-7

As a result of the adoption of rule 206(4)-5, rule 206(4)-7 contains a revised collection of information requirement within the meaning of the PRA. In the Proposing Release, the Commission estimated that registered advisers would spend between 8 hours and 250 hours to establish policies and procedures to comply with rule 206(4)-5.[577] Rule 206(4)-7 contains a currently approved collection of information under OMB control number 3235-0585. The title for the collection of information is "Investment Advisers Act Rule 206(4)-7, Compliance procedures and practices." As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 206(4) of the Advisers Act provides that it shall be unlawful for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)-7, in part, requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. This collection of

574 464 x 1.06 = 491.84.

575 15,228 (current approved burden) + 1,112.32 (burden for additional registrants) - 491.84 (reduction in burden for amendments) = 15,848.48 hours.

576 15,848.48 (revised annual aggregate burden) divided by 2,321 (total number of registrants who rely on rule) = 6.83.

577 *See* Proposing Release, at section III.B.

information is mandatory. The purpose of the information collection requirement is to ensure that registered advisers maintain comprehensive, written internal compliance programs. It also assists the Commission's staff in its examination and oversight program. Information obtained in our examination and oversight program generally is kept confidential.[578]

As we previously noted, we expect that registered investment advisers subject to rule 206(4)-5 will modify their compliance programs to address new obligations under that rule. The current approved collection of information for rule 206(4)-7, set to expire on March 31, 2011, is based on 10,817 registered advisers that were subject to the rule at an average burden of 80 hours each year per respondent for a total of 865,360 burden hours.

Commission records indicate that currently there are approximately 11,607 registered investment advisers.[579] As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 63,200 hours (790 x 80 hours). In addition, although the time needed to comply with rule 206(4)-5 will vary significantly from adviser to adviser, as discussed in detail below, the Commission staff estimates that firms with government clients will spend between 8 hours and 250 hours to implement policies and procedures to comply with the rule, depending on the firm's number of covered associates.[580] Of the

578 Section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

579 This figure is based on registration information from IARD as of April 1, 2010.

580 *See* section IV.B.1. of this Release (describing the cost estimates associated with compliance with rule 206(4)-5).

1,697 registered advisers that we estimate may be affected by rule 206(4)-5,[581] we estimate that approximately 1,271 are smaller firms, 304 are medium firms, and 122 are larger firms.[582] We anticipate that smaller firms will spend 8 hours, medium firms will spend 125 hours, and larger firms will spend 250 hours,[583] for a total of 78,668 hours,[584] to implement policies and procedures. Our estimates take into account our staff's observation that some registered advisers have established policies regarding political contributions, which can be revised to reflect the new requirements. The revised annual aggregate burden for all respondents to comply with rule 206(4)-7 thus would be 1,007,228 hours.[585]

D. Rule 0-4

Rule 0-4 under the Advisers Act,[586] entitled "General Requirements of Papers and Applications," prescribes general instructions for filing an application seeking exemptive relief with the Commission. The requirements of rule 0-4 are designed to provide the Commission with the necessary information to assess whether granting the orders of exemption are necessary and appropriate, in the public interest and consistent with the protection of investors and the intended purposes of the Act. In light of the adoption of rule 206(4)-5, which contains a provision for seeking an exemptive order from the

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581 *See supra* note 558. Advisers that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act [15 U.S.C. 80b-3(b)(3)] are not subject to rule 206(4)-7 and, therefore, are not reflected in this burden estimates pursuant to the PRA.

582 *See supra* note 475.

583 *See supra* notes 489-491.

584 (1,271 x 8 = 10,168) + (304 x 125 = 38,000) + (122 x 250 = 30,500) = 78,668.

585 865,360 (current approved burden) + 63,200 (burden for additional registrants) + 78,668 (burden attributable to rule 206(4)-5) = 1,007,228 hours.

586 17 CFR 275.0-4.

Commission, we are revising the collection of information requirement for rule 0-4. Rule 0-4 contains a currently approved collection of information under OMB control number 3235-0633. As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The current approved collection of information contains an estimated total annual hour burden of one hour for administrative purposes because most of the work of preparing an application is performed by outside counsel and, therefore, imposes minimal, if any, hourly burden on respondents. Because we expect that all, or substantially all, of the work of preparing an application for an exemptive order under rule 206(4)-5 will also be performed by outside counsel, we continue to believe that the current estimate of one hour, in the unlikely event the adviser does perform an administrative role, is sufficient. As a result, we are not increasing our estimated hourly burden in connection with the adoption of rule 206(4)-5.

The current approved collection of information also contains an estimated total annual cost burden of $355,000, which is attributed to outside counsel legal fees. In the Proposing Release, we estimated that approximately five advisers annually would apply to the Commission for an exemption from rule 206(4)-5.[587] We also estimated that an advisory firm that applies for an exemption would hire outside counsel to prepare their exemptive requests, and that counsel would spend 16 hours preparing an submitting an application for review at a rate of $400 per hour, for a per application cost of $6,400 and a total estimated cost for five applications annually of $32,000.

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[587] *See* Proposing Release, at Section III.B.

The Commission requested public comment on these estimates in the Proposing Release, and we received comments indicating that our estimate of five exemptive application submissions per year is too low.[588] We did not receive comments on our cost estimates. Given that the advisory industry is much larger than the municipal securities industry, and in light of the number of comment letters we received that expressed concern about inadvertent violations of the rule that would not qualify for the exception for returned contributions, our staff estimates that approximately seven advisers annually would apply to the Commission for an exemption from the rule. Although we may initially receive more than seven applications a year for an exemption, over time, we expect the number of applications we receive will significantly decline to an average of approximately seven annually. We continue to believe that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, but based on commenters concerns have raised the number of hours counsel will spend preparing and submitting an application from 16 hours to 32 hours, at a rate of $400 per hour.[589] As a result, each application will cost approximately $12,800, and the total estimated cost for seven applications annually will be $89,600. The total estimated annual cost burden to applicants of filing all applications has therefore increased to $444,600.[590]

VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Final Regulatory Flexibility Analysis regarding rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3 in accordance

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588 *See* Davis Polk Letter; ICI Letter.

589 The hourly cost estimate of $400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

590 $355,000 + $89,600 = $444,600.

with section 3(a) of the Regulatory Flexibility Act.[591] We prepared an Initial Regulatory Flexibility Analysis ("IRFA") in conjunction with the Proposing Release in August 2009.[592] The Proposing Release included, and solicited comment, on the IRFA.

A. Need for the Rule

Investment advisers that seek to influence the award of advisory contracts by government entities, by making or soliciting political contributions to those officials who are in a position to influence the awards, violate their fiduciary obligations. These practices—known as "pay to play"—distort the process by which investment advisers are selected and, as discussed in greater detail above, can harm advisers' public pension plan clients, and thereby beneficiaries of those plans, which may receive inferior advisory services and pay higher fees.[593] In addition, the most qualified adviser may not be selected, potentially leading to inferior management, diminished returns, or greater losses for the public pension plan. Pay to play is a significant problem in the management of public funds by investment advisers. Moreover, we believe that advisers' participation in pay to play is inconsistent with the high standards of ethical conduct required of them under the Advisers Act. The rule and rule amendments we are adopting today are designed to prevent fraud, deception, and manipulation by reducing or eliminating adviser participation in pay to play practices.

Rule 206(4)-5, the "pay to play" rule, prohibits an investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act, from providing

[591] 5 U.S.C. 604(b).

[592] *See* Proposing Release, at section V.

[593] *See* section I of this Release, for more information about the need for the Commission to take action to prevent pay to play practices.

advisory services for compensation to a government client for two years after the adviser, or any of its covered associates, makes a contribution to public officials (and candidates) such as state treasurers, comptrollers, or other elected executives or administrators who can influence the selection of the adviser.[594] In addition, the rule we are adopting prohibits an adviser and its covered associates from soliciting contributions for an elected official or candidate or payments to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity,[595] and from providing or agreeing to provide, directly or indirectly, payment to any third party, other than a "regulated person," engaged to solicit advisory business from any government entity on behalf of the adviser.[596] Further, the prohibitions in the rule also apply to advisers to certain investment pools in which a government entity invests or that are investment options of a plan or program of a government entity.[597] The amendment we are adopting to rule 204-2 is designed to provide Commission staff with records to review compliance with rule 206(4)-5, and the amendment to rule 206(4)-3 clarifies the application of the cash solicitation rule as a result of the adoption of rule 206(4)-5.[598]

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the IRFA, in particular, on the number of small entities, particularly small advisers, to which the rule and rule amendments would apply and the effect on those entities, including whether the effects

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594 Rule 206(4)-5(a)(1).

595 Rule 206(4)-5(a)(2)(ii).

596 Rule 206(4)-5(a)(2)(i). "Regulated person" is defined in rule 206(4)-5(f)(9).

597 Rule 206(4)-5(c).

598 For a more detailed discussion of the prohibitions contained in rule 206(4)-5, see section II.B.2 of this Release. For a more detailed discussion of the amendments to rules 204-2 and 206(4)-3, see sections II.D and II.E, respectively, of this Release.

would be economically significant; and how to quantify the number of small advisers, including those that are unregistered, that would be subject to the proposed rule and rule amendments. We received a number of comments related to the impact of our proposal on small advisers. The commenters argued that the proposed rule, particularly the provision that would have prohibited advisers from directly or indirectly compensating any third party to solicit government business on its behalf, would be disproportionately expensive for, and would impose an undue regulatory burden on, smaller firms.[599]

C. Small Entities Subject to Rule

Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[600]

The Commission estimates that as of April 2010 there are approximately 708 small SEC-registered investment advisers.[601] Of these 708 advisers, 61 indicate on Form ADV that they have state or local government clients, and would, therefore, be affected

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599 *See supra* note 522.

600 17 CFR 275.0-7(a).

601 This estimate is based on registration information from IARD as of April 1, 2010. We have estimated the number of small advisers by reference to advisers' responses to Item 12.A, B and C of Part 1 of Form ADV.

by the rule.[602] The rule also applies to those advisers that are exempt from registration with the Commission in reliance on section 203(b)(3) of the Advisers Act. As noted above, based on our review of registration information on IARD and outside sources and reports, we estimate that there are approximately 2,000 advisers that are unregistered in reliance on section 203(b)(3).[603] Applying the same principles we used with respect to registered investment advisers, we estimate that 230 of those advisers manage pooled investment vehicles in which government client assets are invested and would therefore be subject to the rule.[604] Based on the current number of registered advisers subject to the rule that are small entities, we estimate that approximately 4 percent of unregistered advisers,[605] or nine, would be subject to the rule are small entities.[606]

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602 This estimate is based on registration information from IARD as of April 1, 2010. We have estimated the number of small advisers with state or local government clients by reference to advisers' responses to Item 5.D(9) of Part 1 of Form ADV.

603 This number is based on our review of registration information on IARD as of April 1, 2010, IARD data from the peak of hedge fund adviser registration in 2005, and a distillation of numerous third-party sources including news organizations and industry trade groups.

604 11.48% of 2000 is 230. *See supra* note 474.

605 61 registered small entities subject to the rule/1,697 registered advisers subject to the rule = 3.6%.

606 230 x 4% = 9.2. Because these advisers are not registered with us, we do not have more precise data about them, and we are not aware of any databases that compile information regarding how many advisers that are exempt from registration with the Commission in reliance on section 203(b)(3) of the Advisers Act have state or local government clients, and how many of these advisers would be small entities for purposes of this analysis. We sought comments on this issue, but none of the comments we received provided any estimates or empirical data. However, we address above commenters who generally questioned our estimates. *See* supra notes 482-484 and accompanying text. We expect certain additional advisers may incur compliance costs associated with rule 206(4)-5. Some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The rule imposes certain reporting, recordkeeping and compliance requirements on advisers, including small advisers. The rule imposes a new compliance requirement by: (i) prohibiting an adviser from providing investment advisory services for compensation to government clients for two years after the adviser or any of its covered associates makes a contribution to certain elected officials or candidates; (ii) prohibiting an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party, other than a "regulated person," engaged to solicit advisory business from any government entity on behalf of the adviser; and (iii) prohibiting an adviser or any of its covered associates from soliciting contributions for an elected official or candidate or payments to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity.

The rule amendments impose new recordkeeping requirements by requiring an adviser to maintain certain records about its covered associates, its advisory clients, government entities invested in certain pooled investment vehicles managed by the adviser, its solicitors, and its political contributions, as well as the political contributions of its covered associates.[607] An investment adviser that does not provide or seek to provide advisory services to a government entity, or to a covered investment pool in which a government entity invests, is not subject to rule 206(4)-5 and certain recordkeeping requirements under amended rule 204-2.

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[607] *See supra* notes 559-564 and accompanying text (providing the revised estimated hour burden and non-labor cost burden to comply with amended rule 204-2, for purposes of the PRA).

As noted above, we believe that a limited number of small advisers[608] will have to comply with rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3. To the extent small advisers tend to have fewer clients and fewer employees that would be covered associates for purposes of the rule, the rule should impose lower costs on small advisers as compared to large advisers because variable costs, such as the requirement to make and keep records relating to contributions, should be lower due to the likelihood that there would be fewer records to make and keep.[609] Moreover, as discussed above, the rule and amendments were modified from what we had proposed in several ways that we expect will substantially minimize compliance burdens on small advisers.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant impact on small entities.[610] In considering whether to adopt rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule and rule amendments for such small entities; (iii) the use of performance

608 *See* section VI.C of this Release.

609 However, as noted above, many larger advisers with broker-dealer affiliates may spend fewer resources to comply with the proposed rule and rule amendments because they may be able to rely on compliance procedures and systems that the broker-dealer already has in place to comply with MSRB rules G-37 and G-38. *See supra* section IV.B.

610 As noted above, we considered two alternatives to certain aspects of proposed rule 206(4)-5: a disclosure obligation and a two-year time out for third-party solicitors. We do not believe either alternative would accomplish our stated objective of curtailing pay to play activities and thereby address potential harms from those activities. *See* Proposing Release, at section II.A.2, including nn.133 and 134 and accompanying text.

rather than design standards; and (iv) an exemption from coverage of the rule and rule amendments, or any part thereof, for such small entities.

Regarding the first alternative, the Commission is not adopting different compliance or reporting requirements for small advisers as it may be inappropriate to do so under the circumstances. The proposal is designed to reduce or eliminate adviser participation in pay to play, a practice that can distort the process by which investment advisers are selected to manage public pension plans that can harm public pension plan clients and cause advisers to violate their fiduciary obligations. To establish different requirements for small advisers could diminish the protections the rule and rule amendments would provide to public pension plan clients and their beneficiaries.

Regarding the second alternative, we considered whether further clarification, consolidation, or simplification of the compliance requirements would be feasible or necessary, and would reduce compliance requirements. As a result, we have simplified the compliance requirements by limiting the recordkeeping obligations to better reflect the activities of an adviser or a covered associate that could result in the adviser being subject to the two-year time out, including not requiring advisers to maintain records of unsuccessful solicitations of government entities and payments (as opposed to contributions) by advisers or covered associates to government officials.[611] Moreover, we are amending rule 206(4)-3, the cash solicitation rule, to clarify that the requirements of new rule 206(4)-5 apply to solicitation activities involving government clients.[612]

611 *See supra* note 423 and accompanying text.

612 *See* section II.D. of this Release.

Regarding the third alternative, we considered using performance rather than design standards with respect to pay to play practices of investment advisers to be neither consistent with the objectives for this rulemaking nor sufficient to protect investors in accordance with our statutory mandate of investor protection. Design standards, which we have employed, provide a base line for advisory conduct as it relates to contributions and other pay to play activities, which is consistent with a rule designed to prohibit pay to play. The use of design standards also is important to ensure consistent application of the rule among investment advisers to which the rule and rule amendments will apply.

Regarding the fourth alternative, exempting small entities could compromise the overall effectiveness of the rule and related rule amendments. Banning pay to play practices benefits clients of both small and large advisers, and it would be inconsistent to specify different requirements for small advisers.

As discussed above, several commenters suggested alternative approaches to our rule.[613] Such alternatives include, for example: (i) that we require advisers to disclose their contributions to state and local officials; (ii) that we require advisers to include in their codes of ethics a policy that prohibits contributions made for the purpose of influencing the selection of the adviser; (iii) that we require advisers to adopt policies and procedures reasonably designed to prevent and detect contributions designed to influence the selection of an adviser; (iv) that we mandate preclearance of employee contributions; and (v) that we allow an adviser to customize sanctions based on the severity of the violation.[614] While it may be true that some of these approaches could diminish the

613 *See generally* section II.B.2(a) of this Release.

614 *See id.*

compliance burdens on advisers, including small advisers, as we explain above, we considered these alternative approaches and do not believe they would appropriately address the kind of conduct at which our rule is directed.[615]

We are sensitive to the burdens our rule amendments will have on small advisers. We believe that the rule we are adopting today contains a number of modifications from what we had proposed that will alleviate many of the commenters' concerns regarding small advisers. Most notably, as described above, we have created an exception to the third-party solicitor ban for "regulated persons," which will, for instance, allow advisers to continue to use third party placement agents to sell interests in covered investment pools they manage instead of incurring additional costs to hire internal marketing staff, a result that could have disproportionally affected small advisers.[616] Moreover, as discussed above, we have modified the exceptions to the rule's two-year time out provisions in certain respects to reduce the likelihood of an inadvertent or minor violation of the rule, including a shortened look back of six months for certain new covered associates whose contributions are less likely to involve pay to play and a new *de minimis* exception for contributions to officials for whom a covered associate is not entitled to vote.[617] We have also limited certain recordkeeping requirements we had proposed in order to achieve our goals in a way that balances the costs and benefits of the rule, including not requiring records of unsuccessful solicitations or payments (that are not contributions) by advisers or covered associates to government officials.[618]

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[615] *See id.*

[616] *See* section II.B.2(b) of this Release.

[617] *See* sections II.B.2(a)(5) and (6) of this Release.

[618] *See* sections II.D and III.B.3. of this Release.

VII. EFFECTS ON COMPETITION, EFFICIENCY AND CAPITAL FORMATION

We are adopting amendments to rule 204-2 pursuant to our authority under sections 204 and 211. Section 204 requires the Commission, when engaging in rulemaking pursuant to that authority, to consider whether the rule is "necessary or appropriate in the public interest or for the protection of investors."[619] Section 202(c) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[620]

In the Proposing Release, we solicited comment on whether, if adopted, the proposed amendments to rule 204-2 would promote efficiency, competition and capital formation. We further encouraged commenters to provide empirical data to support their views on any burdens on efficiency, competition or capital formation that might result from adoption of the proposed amendments. We did not receive any empirical data in this regard concerning the proposed amendments. We received some general comments, addressed below, asserting that the proposed amendments to require registered advisers to maintain books and records relating to investment advisory services they provide to government entities would have an adverse impact on competition.

We are amending rule 204-2 to require a registered adviser to make and keep a list of its covered associates, the government entities to which the adviser directly or

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619 15 U.S.C. 80b-4.

620 15 U.S.C. 80b-2(c). In contrast, we are adopting rule 206(4)-5 and amendments to rule 206(4)-3 pursuant to our authority set forth in sections 206(4) and 211. For a discussion of the effects of these amendments on competition, efficiency and capital formation, see sections IV, V, and VI of this Release.

indirectly provides advisory services, the "regulated person" solicitors the adviser retains, and the contributions made by the firm and its covered associates, as applicable, to government officials and candidates.[621] The amendments are designed to provide our examiners important information about the adviser and its covered associates' contributions to government officials, the government entities to which the adviser directly or indirectly provides advisory services, and the solicitors it retains. These amendments may also benefit advisers as records required under the amended rule will assist the Commission in enforcing the rule against, for example, an adviser whose pay to play activities, if not uncovered, could adversely affect the competitive position of a compliant adviser.

Although we believe that the amendments to the Advisers Act recordkeeping rule will require advisers to incur both one-time costs to establish and enhance current systems to assist in their compliance with the amendments and ongoing costs to maintain records, these costs will be borne by all registered advisers that have government entity clients or that pay regulated entities to solicit government clients on their behalf. As the amendments to the recordkeeping rule do not disproportionally affect any particular group of advisers with government entity clients and do not materially increase the compliance burden on advisers under rule 204-2, we do not believe that they will affect competition across registered investment advisers. Some commenters asserted that certain asset managers that provide advice to government entities but are not subject to the Advisers Act recordkeeping rule, such as banks and advisers that are exempt from registration under the Act, may be at a competitive advantage to registered advisers that

621 Rule 204-2(a)(18)(i).

must incur the costs of keeping records under the rule.[622] While we acknowledge these entities could potentially obtain a competitive advantage for this reason, we do not believe the costs attributable to the amendments to rule 204-2 will have a significant impact on registered advisers such that the advantage gained by asset managers not subject to the Advisers Act recordkeeping rule will be substantial.[623] Moreover, exempt advisers or persons that do not meet the definition of investment adviser are not subject to rule 204-2.[624] Finally, we also note that banks may be subject to laws and rules that do not apply to registered advisers.

We believe that the amendments to rule 204-2 may, to a limited extent, affect efficiency and capital formation with respect to the allocation of public pension plan assets. The amendments to rule 204-2 will allow our staff to examine for compliance with rule 206(4)-5. Authority to examine records may improve registered investment advisers' compliance with rule 206(4)-5, which may reduce the adverse effects of political contributions on the selection of investment advisers. While the amendments to the rule will not affect the aggregate amount of pension fund assets available for investment, limiting the effects of political contributions on the investment adviser

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622 SIFMA Letter ("The books and records requirement under the Proposed Rule are under inclusive. . . . As an initial matter, the books and records requirements apply only to some of the advisers covered by the Proposed Rule – although the Proposed Rule applies to a substantial number of entities who are exempt from registration under the Advisers Act, the Proposed Rule's additional books and records only modify the rules that apply to registered investment advisers.").

623 In addition, we note that advisers not subject to the amendments to rule 204-2 may nonetheless maintain some of the required records as part of a strong compliance program.

624 *See* section 204 of the Advisers Act, 15 U.S.C. 80b-4 (that provides the Commission authority to prescribe recordkeeping for advisers, other than those specifically exempted from registration).

selection process should improve the mechanism by which capital is formed and allocated to investment opportunities.

VIII. STATUTORY AUTHORITY

The Commission is adopting new rule 206(4)-5 and amending rule 206(4)-3 of the Advisers Act pursuant to the authority set forth in sections 206(4) and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-6(4), 80b-11(a)].

The Commission is amending rule 204-2 of the Advisers Act pursuant to the authority set forth in sections 204 and 211(a) of the Advisers Act [15 U.S.C. 80b-4 and 80b-11(a)].

List of Subjects in 17 CFR Part 275

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

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

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

* * * * *

2. Section 275.204-2 is amended by adding paragraph (a)(18) and by revising paragraph (h)(1) to read as follows:

§ 275.204-2 -- Books and records to be maintained by investment advisers.

(a) * * *

(18)(i) Books and records that pertain to § 275.206(4)-5 containing a list or other record of:

(A) The names, titles and business and residence addresses of all covered associates of the investment adviser;

(B) All government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years, but not prior to [insert date 60 days after publication in Federal Register];

(C) All direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a political party of a state or political subdivision thereof, or to a political action committee; and

(D) The name and business address of each regulated person to whom the investment adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf, in accordance with § 275.206(4)-5(a)(2).

(ii) Records relating to the contributions and payments referred to in paragraph (a)(18)(i)(C) of this section must be listed in chronological order and indicate:

(A) The name and title of each contributor;

(B) The name and title (including any city/county/state or other political subdivision) of each recipient of a contribution or payment;

(C) The amount and date of each contribution or payment; and

(D) Whether any such contribution was the subject of the exception for certain returned contributions pursuant to § 275.206(4)-5(b)(2).

(iii) An investment adviser is only required to make and keep current the records referred to in paragraphs (a)(18)(i)(A) and (C) of this section if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services.

(iv) For purposes of this section, the terms "contribution," "covered associate," "covered investment pool," "government entity," "official," "payment," "regulated person," and "solicit" have the same meanings as set forth in § 275.206(4)-5.

* * * * *

(h)(1) Any book or other record made, kept, maintained and preserved in compliance with §§ 240.17a-3 and 240.17a-4 of this chapter under the Securities Exchange Act of 1934, or with rules adopted by the Municipal Securities Rulemaking Board, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this section, shall be deemed to be made, kept, maintained and preserved in compliance with this section.

* * * * *

3. Section 275.206(4)-3 is amended by adding paragraph (e) and removing the authority citation following the section to read as follows:

§ 275.206(4)-3 Cash payments for client solicitations.

* * * * *

(e) Special rule for solicitation of government entity clients. Solicitation activities involving a government entity, as defined in § 275.206(4)-5, shall be subject to the additional limitations set forth in that section.

4. Section 275.206(4)-5 is added to read as follows:

§ 275.206(4)-5 Political contributions by certain investment advisers.

(a) Prohibitions. As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)), it shall be unlawful:

(1) For any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)) to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made); and

(2) For any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)) or any of the investment adviser's covered associates:

(i) To provide or agree to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless such person is a regulated person or is an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the investment adviser; and

(ii) To coordinate, or to solicit any person or political action committee to make, any:

(A) Contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or

(B) Payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

(b) Exceptions.

(1) De minimis exception. Paragraph (a)(1) of this section does not apply to contributions made by a covered associate, if a natural person, to officials for whom the covered associate *was* entitled to vote at the time of the contributions and which in the aggregate do not exceed $350 to any one official, per election, or to officials for whom the covered associate was *not* entitled to vote at the time of the contributions and which in the aggregate do not exceed $150 to any one official, per election.

(2) Exception for certain new covered associates. The prohibitions of paragraph (a)(1) of this section shall not apply to an investment adviser as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the investment adviser unless such person, after becoming a covered associate, solicits clients on behalf of the investment adviser.

(3) Exception for certain returned contributions.

(i) An investment adviser that is prohibited from providing investment advisory services for compensation pursuant to paragraph (a)(1) of this section as a result of a contribution made by a covered associate of the investment adviser is excepted from such prohibition, subject to paragraphs (b)(3)(ii) and (b)(3)(iii) of this section, upon satisfaction of the following requirements:

(A) The investment adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution;

(B) Such contribution must not have exceeded $350; and

(C) The contributor must obtain a return of the contribution within 60 calendar days of the date of discovery of such contribution by the investment adviser.

(ii) In any calendar year, an investment adviser that has reported on its annual updating amendment to Form ADV (17 CFR 279.1) that it has more than 50 employees is entitled to no more than three exceptions pursuant to paragraph (b)(3)(i) of this section, and an investment adviser that has reported on its annual updating amendment to Form ADV that it has 50 or fewer employees is entitled to no more than two exceptions pursuant to paragraph (b)(3)(i) of this section.

(iii) An investment adviser may not rely on the exception provided in paragraph (b)(3)(i) of this section more than once with respect to contributions by the same covered associate of the investment adviser regardless of the time period.

(c) Prohibitions as applied to covered investment pools. For purposes of this section, an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity.

(d) Further prohibition. As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of section 206(4) of Advisers Act (15 U.S.C. 80b-6(4)), it shall be unlawful for any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)), or any of the investment adviser's covered associates to do anything indirectly which, if done directly, would result in a violation of this section.

(e) Exemptions. The Commission, upon application, may conditionally or unconditionally exempt an investment adviser from the prohibition under paragraph (a)(1) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors:

(1) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Advisers Act (15 U.S.C. 80b);

(2) Whether the investment adviser:

(i) Before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of this section; and

(ii) Prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and

(iii) After learning of the contribution:

(A) Has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution; and

(B) Has taken such other remedial or preventive measures as may be appropriate under the circumstances;

(3) Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment;

(4) The timing and amount of the contribution which resulted in the prohibition;

(5) The nature of the election (*e.g*, federal, state or local); and

(6) The contributor's apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.

(f) Definitions. For purposes of this section:

(1) Contribution means any gift, subscription, loan, advance, or deposit of money or anything of value made for:

(i) The purpose of influencing any election for federal, state or local office;

(ii) Payment of debt incurred in connection with any such election; or

(iii) Transition or inaugural expenses of the successful candidate for state or local office.

(2) Covered associate of an investment adviser means:

(i) Any general partner, managing member or executive officer, or other individual with a similar status or function;

(ii) Any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and

(iii) Any political action committee controlled by the investment adviser or by any person described in paragraphs (f)(2)(i) and (f)(2)(ii) of this section.

(3) Covered investment pool means:

(i) An investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a) that is an investment option of a plan or program of a government entity; or

(ii) Any company that would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), but for the exclusion provided from that definition by either section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act (15 U.S.C. 80a-3(c)(1), (c)(7) or (c)(11)).

(4) Executive officer of an investment adviser means:

(i) The president;

(ii) Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);

(iii) Any other officer of the investment adviser who performs a policy-making function; or

(iv) Any other person who performs similar policy-making functions for the investment adviser.

(5) Government entity means any state or political subdivision of a state, including:

(i) Any agency, authority, or instrumentality of the state or political subdivision;

(ii) A pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a "defined benefit plan" as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a state general fund;

(iii) A plan or program of a government entity; and

(iv) Officers, agents, or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

(6) Official means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office:

(i) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or

(ii) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.

(7) Payment means any gift, subscription, loan, advance, or deposit of money or anything of value.

(8) Plan or program of a government entity means any participant-directed investment program or plan sponsored or established by a state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to, a "qualified tuition plan" authorized by section 529 of the Internal Revenue Code (26 U.S.C. 529), a retirement plan authorized by section 403(b) or 457 of the Internal Revenue Code (26 U.S.C. 403(b) or 457), or any similar program or plan.

(9) Regulated person means:

(i) An investment adviser registered with the Commission that has not, and whose covered associates have not, within two years of soliciting a government entity:

(A) Made a contribution to an official of that government entity, other than as described in paragraph (b)(1) of this section; and

(B) Coordinated or solicited any person or political action committee to make any contribution or payment described in paragraphs (a)(2)(ii)(A) and (B) of this section; or

(ii) A "broker," as defined in section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) or a "dealer," as defined in section 3(a)(5) of that Act (15 U.S.C. 78c(a)(5)), that is registered with the Commission, and is a member of a national securities association registered under section 15A of that Act (15 U.S.C. 78o-3), provided that:

(A) The rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and

(B) The Commission, by order, finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers than this section imposes on investment advisers and that such rules are consistent with the objectives of this section.

(10) Solicit means:

(i) With respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and

(ii) With respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 1, 2010

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62427/July 1, 2010

Admin. Proc. File No. 3-13304

In the Matter of DAN RAPOPORT	ORDER DENYING ORAL ARGUMENT

Dan Rapoport, formerly the executive director of OOO Centreinvest Securities, requests that we grant oral argument in connection with his motion to set aside or modify a July 31, 2009 default judgment and to review a March 22, 2010 order denying his earlier request to set aside that judgment.[1]

Commission Rule of Practice 451(a) states that "[t]he Commission will consider appeals, motions and other matters properly before it on the basis of the papers filed by the parties without oral argument unless the Commission determines that the presentation of facts and legal arguments in the briefs and record and the decisional process would be significantly aided by oral argument."[2] It does not appear, however, that the decisional process would be significantly aided by oral argument in this case.

Accordingly, it is ORDERED that Dan Rapoport's motion for oral argument be, and it hereby is, denied.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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1 *See Centreinvest, Inc., Order Making Findings and Imposing Sanctions by Default as to Centreinvest, Inc., Dan Rapoport, and Svyatoslav Yenin*, Securities Exchange Act Rel. No. 60413 (July 31, 2009), 96 SEC Docket 19387; *Centreinvest, Inc., Order Denying Motion to Set Aside Default and Correcting Sanction,* Exchange Act Rel. No. 61751 (Mar. 22, 2010), 98 SEC Docket 26614.

2 17 C.F.R. § 201.451(a).

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62438 / July 1, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13846

In the Matter of **QAIS R. BHAVNAGARI,** **Respondent.**	**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") instituted public administrative proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Qais R. Bhavnagari ("Respondent") on April 5, 2010.

II.

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

III.

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

1. From May 2005 through May 2009, Bhavnagari was a registered representative associated with Aura Financial Services, Inc. ("Aura"), a broker-dealer registered with the Commission. Bhavnagari, 28 years old, was a resident of Sunny Isles, Florida at all relevant times.

2. On March 15, 2010, a final judgment was entered by consent against Bhavnagari, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Aura Financial Services, Inc., et al., Civil Action Number 09-CIV-21592, in the United States District Court for the Southern District of Florida.

3. The Commission's complaint alleged that, between September 2007 and September 2008, Bhavnagari made false or misleading statements of material facts to Aura clients. Additionally, the complaint alleged that from January 2008 through March 2009, Bhavnagari "churned" the accounts of Aura clients by engaging in excessive trading to generate commissions for himself rather than in the clients' interests. The complaint alleged that these actions operated as a fraud and deceit on the investors.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Bhavnagari be, and hereby is barred from association with any broker or dealer with the right to reapply for association after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

Any reapplication for association by 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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3044 / July 2, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13953

In the Matter of **STEPHEN MICHAEL ALEXANDER,** **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 Stephen Michael Alexander ("Alexander" or "Respondent").

II.

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

III.

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

1. Alexander was the President and Chief Executive Officer of Hartford Investments, Inc. ("Hartford"), an investment adviser. Alexander, 59 years old, is a resident of Villanova, Pennsylvania.

2. On March 16, 2010, Alexander pled guilty to two counts of wire fraud in violation of Title 18 United States Code, Section 1343 and one count of money laundering in violation of Title 18 United States Code, Section 1956 before the United States District Court for the Eastern District of Pennsylvania, in *United States v. Michael Alexander*, Crim. Information No. 2:10 CR-00038-TJS (March 16, 2010).

3. The counts of the criminal information to which Alexander pled guilty alleged, *inter alia*, that Alexander sought investors by falsely claiming that he operated Hartford as a hedge fund and that he further falsely claimed that he managed approximately $300 million from approximately 28 clients, including $17 million of his own money. Alexander offered to manage investors' funds in exchange for 10 percent of each investor's net profits. Alexander told investors that their money would be kept in separate accounts, when in fact he commingled their funds with other investor funds and his own funds. Alexander also sent out false statements to his clients showing that the value of their investments was consistently increasing. In reality, Alexander invested some funds in investments that lost money, and used much of the money for his own personal living expenses. In total, Alexander raised approximately $12 million. As part of his plea, Alexander agreed to pay full restitution in the amount of $7.5 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 Alexander's Offer.

Accordingly, it is hereby ORDERED:

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 242

[Release No. 34-62445; File No. S7-21-09]

RIN 3235-AK40

Elimination of Flash Order Exception from Rule 602 of Regulation NMS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; reopening of comment period.

SUMMARY: The Securities and Exchange Commission ("Commission") is reopening the period for public comment on a proposal to eliminate the flash order exception with respect to listed options from Rule 602 of Regulation NMS under the Securities Exchange Act of 1934 ("Exchange Act"). The proposal originally was published in Securities Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009).

DATES: Comments should be received on or before [insert date 30 days after date of publication in Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-21-09 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

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

All submissions should refer to File No. S7-21-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, N.E., 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; 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: Theodore S. Venuti, Special Counsel, at (202) 551-5658, Arisa Tinaves, Special Counsel, at (202) 551-5676, 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.

SUPPLEMENTARY INFORMATION:

I. Introduction

Rule 602 of Regulation NMS[1] and Rule 301(b) of Regulation ATS[2] require exchanges and alternative trading systems ("ATSs"), respectively, to provide their best-priced quotations to the consolidated quotation data that is widely disseminated to the public.[3] In September 2009,

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1 17 CFR 242.602.

2 17 CFR 242.301(b).

3 Consolidated quotation data captures the best-priced quotations from exchanges, ATSs, and other trading centers for listed cash equities and options. This core data for a security

the Commission proposed to amend Rule 602(a)(1)(i)(A) to eliminate an exception for the use of flash orders with respect to trading in both NMS stocks and listed options ("Proposal").[4] The exception applies to quotations that are executed immediately after communication, or cancelled or withdrawn if not executed immediately after communication. Flash orders are exposed to some market participants for a brief period of time (generally less than one second), but are not included in the consolidated quotation data pursuant to the Rule 602 exception. Moreover, flash orders generally are immediately executable at prices that equal (or "lock") the best displayed quotations on the contra side of the market, yet the orders are flashed rather than being immediately routed away to another market to execute against the quotations that establish the best prices.

With respect to listed options, the Commission is reopening the comment period to invite additional comment on the issues set forth in this release, as well as any other issues that the public wishes to address with respect to the Proposal as it would affect the listed options markets.

Of the 93 commenters that submitted views on the Proposal to the Commission, 67 generally supported the Proposal, 12 generally opposed the Proposal, and another 9 opposed the Proposal specifically for trading in listed options.[5] Supporters generally believed that

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is consolidated and distributed to the public by a single central processor pursuant to Commission rules.

4 Securities Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009) ("Proposing Release"). The Proposing Release contains a detailed description of a flash order. <u>See</u> Proposing Release at 48633 – 48634.

5 In addition to the supporting and opposing commenters, five commenters neither supported nor opposed the Proposal. Copies of comments received on the Proposal are available on the Commission's Internet Web site, located at http://www.sec.gov/comments/s7-21-09/s72109.shtml, and in the Commission's Public Reference Room at its Washington, DC headquarters.

eliminating the flash order exception would address the potential for two-tiered access to information concerning the best available prices for a security, encourage the public display of liquidity, and enhance the fairness of the markets for investors.[6] Those opposing the Proposal generally believed that flash orders can benefit investors by attracting additional liquidity and by helping to minimize trading fees.[7]

Specifically with respect to listed options, those opposing the Proposal focused on the differences between the cash equity and the listed options markets. For example, four commenters addressing the Proposal for listed options emphasized that there is no regulatory cap on the fees charged by listed options exchanges to access their best displayed quotations,[8] in contrast to access fees in the cash equity markets which generally are capped at $0.003 cents per share by Rule 610(c) of Regulation NMS. Moreover, a commenter emphasized that access fees are significantly higher in the options markets than in the cash equity markets, on both an absolute basis ($0.003 per share for cash equities and $0.0045 (per share equivalent) for options on one exchange) and a percentage basis (0.0176% of the average stock price for retail investors and 0.266% of the average option price for retail investors).[9] Commenters also were concerned

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6 Supporting commenters included individuals, industry groups, exchanges, and broker-dealers.

7 Opposing commenters included 6 individuals, exchanges, an electronic communication network ("ECN"), a broker-dealer, and two academics.

8 Letter from John C. Nagel, Managing Director and Deputy General Counsel, Citadel Investment Group, Inc. ("Citadel") dated November 20, 2009 ("Citadel Letter") at 2; Letter from Peter Bottini, EVP Trading and Customer Service, and Hillary Victor, Associate General Counsel, optionsXpress, Inc. ("optionsXpress") dated November 25, 2009 ("optionsXpress Letter") at 3; Letter from Thomas F. Price, Managing Director, Securities Industry and Financial Markets Association ("SIFMA") dated December 1, 2009 ("SIFMA Letter") at 5; Letter from Christopher Nagy, Managing Director Order Strategy, TD Ameritrade, Inc. ("TD Ameritrade"), dated November 23, 2009 ("TD Ameritrade Letter") at 2.

9 Citadel Letter at 5.

that, in the absence of a fee cap for options, elimination of the flash order exception could lead to even higher access fees.[10]

To assess further these commenter concerns and other issues, the Commission is reopening the comment period for the proposed elimination of the flash order exception with respect to listed options. Additional comment is requested below on, among other things the effect of a proposed cap on access fees for listed options,[11] and on the execution quality that flash orders receive in the options markets. The Commission is particularly interested in the extent to which flash orders, if they fail to receive an execution in the flash process, "miss the market" by either receiving an inferior price through an execution against a displayed quotation or no execution at all. No useful data was provided on this crucial execution quality issue during the initial comment period. Two exchanges that use flash order mechanisms indicated that their fill rates for flash orders were in the range of 60-70%.[12] They did not, however, provide data on the execution quality, including implementation shortfall, of orders that failed to receive an execution in the flash process.

II. Requests for Comment

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10 Citadel Letter at 6; TD Ameritrade Letter at 4.

11 See Securities Exchange Act Release No. 61902 (April 14, 2010), 75 FR 20738 (April 20, 2010) ("Access Fee Release") (proposing a new rule relating to access to quotations for listed options that would cap access fees). Commenters on this release and on the Access Fee Release should be aware that the flash order and access fee issues, though related, are not necessarily linked. In formulating their views, commenters should recognize that the Commission will assess each proposal individually and could decide to take further action on one or both.

12 Letter from Tony McCormick, Chief Executive Officer, Boston Options Exchange Group, LLC ("BOX"), dated November 23, 2009 ("BOX Letter") at 1; Letter from Michael J. Simon, General Counsel, Secretary and Chief Regulatory Officer, International Securities Exchange, LLC ("ISE"), dated November 23, 2009 ("ISE Letter") at 4.

1. Commenters argued that flash orders were necessary in the options markets to avoid the access fees that otherwise would be charged if the orders were routed to other exchanges. If the Commission adopted a cap on access fees for listed options, would the change remove the need for exchanges to use flash orders to prevent their customers from incurring high access fees? Would the reduction in benefits of flash orders for listed options go beyond the direct effect of the reduction in access fees, such as through an impact on spreads or order book liquidity? If so, how much weight should be given to this net reduction in benefits of flash orders in the Commission's analysis of the costs and benefits of the Proposal to eliminate the flash order exception for listed options?

2. Comment and data are requested on the execution quality, including implementation shortfall of latency or nonexecution, received by investor orders in listed options that are placed in a flash mechanism.[13] What percentage of such orders are executed in the flash mechanism (that is, by execution against a flash responder)? How do the average access fees paid by these flashed orders compare to the average access fees the orders would have paid if they had been routed to an exchange posting the best quote? For orders that do not receive an execution in the flash mechanism, what percentage are routed to other exchanges, and what percentage of orders routed to other exchanges receive an execution? What proportions of flashed orders that received a flash execution, or that were executed at other markets,

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13 Implementation shortfall measures two components of order execution quality for marketable flash orders. First, for orders that are executed (whether at the flashing exchange or after routing to another exchange), it measures the difference between the trade price and the relevant quotation at the time of order receipt at the flashing exchange (the national best offer for buy orders and the national best bid for sell orders). Second, for orders that are cancelled without any execution or with only a partial execution, implementation shortfall measures the difference between the relevant quotation (as described for executed orders) and an imputed price based on the relevant quotation when the order is cancelled.

respectively, received an execution at a price better than, equal to, or worse than the national best bid or offer ("NBBO") at the time of order receipt at the exchange that flashed the order? Are flash orders used more often in certain market conditions, such as at times with wider bid-ask spreads? If so, please divide the statistics above by those market conditions.

3. Comment and data are requested on the execution quality received by investor orders in listed options that are not flashed. To what extent do marketable orders receive executions at prices that are better than, equal to, or worse than the NBBO at the time of order receipt at the exchange that initially receives the order? We understand that execution quality statistics comparable to those requested above are not widely available to investors and brokers in the listed options markets. Are they available to any investors or brokers to assess the execution quality of flashed orders? To the extent that they are not available, how are investors and brokers able to assess execution quality for flashed orders? For example, if investors and brokers do not have execution quality statistics for non-flashed orders in the options markets, how would they be able to compare the execution quality of flashed orders with the execution quality of orders that are not flashed?

4. What steps do brokers take to assess whether flashed orders in listed options "miss the market" by failing to receive either any execution or an execution at the NBBO price when the flashing exchange initially received the order? What data or other objective evidence do brokers use to assess whether flashed orders receive best execution?[14]

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[14] The Commission notes that the "Recommendations for Quality of Execution Reports for Options Exchanges" issued by the SIFMA Equity Options Trading Committee on July 17, 2008 ("SIFMA Recommendations") do not appear to provide relevant information on whether flashed orders miss the market. The SIFMA Recommendations specifically exclude orders that an exchange routes away for execution elsewhere from the exchange's execution quality statistics. The SIFMA Recommendations are available at http://www.sifma.org/assets/0/232/234/274/bbc1f723-af5b-45ed-b2f2-1ae7d2f2127d.pdf.

5. One commenter suggested that only in "rare" instances do flashed orders that are routed away "miss the NBBO market," and that in those rare instances the brokers typically honor the NBBO for their customers.[15] Do commenters agree with this statement? Does your answer depend on whether the NBBO benchmark that is honored is understood to be the NBBO at the time of order receipt at the flashing exchange, or the NBBO at some other time? Do commenters have any data to support their conclusion?

6. Several commenters stated that liquidity providers at "maker/taker" options exchanges quote more aggressively – that is, by displaying quotations that either improve the NBBO or are alone at the NBBO – because of the rebates paid to liquidity providers that are funded from the access fees charged to liquidity takers.[16] Do commenters agree that liquidity providers on maker/taker exchanges quote more aggressively than other exchanges once their displayed quotations are adjusted to account for the effect of access fees on the "all in" cost to the investor? If so, are liquidity rebates the only reason that liquidity providers on maker/taker exchanges are willing to quote aggressively? For example, does the absence of order flow captured by payments to routing brokers and the absence of guaranteed allocations for liquidity providers also contribute significantly to aggressive quoting by liquidity providers on maker/taker exchanges?

7. The Commission notes the distinction between "aggressive" quotations and "matching" quotations. Aggressive quotations are price leaders and help narrow the NBBO spread (by either improving the NBBO or remaining alone at the NBBO). Matching quotations follow prices set elsewhere and add size to the NBBO, but do not narrow the spread. To what

15 CBOE Letter at 5 n. 5.

16 ISE Letter at 8; Letter from Larry Harris, Professor of Finance and Business Economics, USC Marshall School of Business, dated December 4, 2009 ("Harris Letter") at 2.

extent do liquidity providers on payment for order flow options exchanges quote aggressively rather than merely matching the NBBO set elsewhere? Would eliminating the flash order exception lead one or both types of options exchange to quote more aggressively and thereby narrow NBBO spreads for listed options? Does your answer change depending on whether the Commission adopts a cap on access fees in the options markets that is substantially less than the access fees currently charged?

8. Does the availability of the flash mechanism at payment for order flow options exchanges play a significant role in enabling such exchanges to compete for order flow through broker payments, rather than through offering better prices for the execution of investor orders? Would eliminating the flash order exception lead payment for order flow options exchanges to respond competitively by more aggressive quoting or through greater use of price improvement mechanisms targeted at non-professional customer order flow?[17]

9. One commenter noted that there is no over-the-counter ("OTC") trading in listed options and that, as a result, more "good" order flow (that is, order flow relatively uninformed about future prices) reaches the options exchanges than the cash equity exchanges.[18] Another noted that, because quotations must be available for execution to all incoming order flow – both informed and uninformed – the quotations must be wider than the prices that could be offered exclusively to uninformed order flow.[19] (Prices that could be offered exclusively to uninformed order flow could incorporate tighter spreads because the market maker does not need to protect itself from adverse selection by informed traders by building in a wider spread.) Do commenters

17 In general, a price improvement mechanism exposes incoming marketable orders to a competitive auction that provides an opportunity for the orders to be executed at better prices than the NBBO.

18 ISE Letter, Appendix B at 2.

19 Harris Letter at 4.

agree with these statements? If so, do mechanisms that offer price improvement attract a large percentage of customer order flow in listed options? Why or why not?

In this regard, what percentage of order flow in listed options participates in the price improvement mechanisms offered by exchanges? Is it less than 1% of order flow at most exchanges? Would the figure be higher if the Commission eliminated the flash order exception? Are there other reasons why price improvement mechanisms do not attract significant order flow? Do exchanges need more flexibility in distinguishing between informed and uninformed order flow as a means to offer better prices to customers that are not professional traders? Must price improvement mechanisms guarantee the NBBO to attract order flow?

10. What is the effect on order execution quality, as well as on the nature of competition in the options markets, of the absence of publicly available order execution quality data comparable to the data that is available for cash equities under Rule 605 of Regulation NMS? How do investors and customers assess best execution issues for flash orders in the absence of mandatory execution quality statistics?

III. Conclusion

The Commission requests comment and data on the issues discussed above, as well as reiterating its discussion and all requests for comment in the Proposing Release with respect to listed options. It is reopening the comment period on the Proposal to obtain the advantage of the public's views on all these issues.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 2, 2010

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62447 / July 2, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3047 / July 2, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13956

In the Matter of **APPALOOSA MANAGEMENT L.P.** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Appaloosa Management L.P. ("Appaloosa Management" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940, Making

Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

1. These proceedings arise out of a violation of Rule 105 of Regulation M of the Exchange Act by Appaloosa Management, an unregistered investment adviser based in Short Hills, New Jersey. Rule 105 prohibits short selling of equity securities during a restricted period and then purchasing the same securities in a public offering. Appaloosa Management violated Rule 105 in connection with short sales it effected within the Rule 105 restricted period preceding its participation in a public offering by Wells Fargo & Co. ("Wells Fargo"), resulting in profits of $842,500.

Respondent

2. Appaloosa Management L.P. is a limited partnership organized under the laws of New Jersey with its principal place of business in Short Hills, NJ. During the relevant time period, Appaloosa Management was the investment adviser to four investment funds, two of which were involved in these proceedings, Appaloosa Investment Limited Partnership I ("Appaloosa Fund") and Palomino Fund Ltd. ("Palomino Fund") (collectively, the "Funds"), with total assets under management in 2008 of approximately $7 billion. Appaloosa Management is not registered with the Commission in any capacity.

Background

3. Rule 105 of Regulation M of the Exchange Act makes it unlawful for a person to purchase securities in a public offering if that person sold short the security that is the subject of the offering during the restricted period defined in the rule. Rule 105 defines the restricted period as the period: (1) beginning five business days prior to the pricing of the offered securities and ending with such pricing; or (2) beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing. 17 C.F.R. Ch. II §242.105. Pursuant to amendments that became effective in October 2007, it is not required that the shares purchased in the offering be used to "cover" the restricted period short sales. Short Selling in Connection with a Public Offering, Rel. No. 34-56206, 72 Fed. Reg. 45094 (Aug. 10, 2007) (effective Oct. 9, 2007).

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

4. Between October 31 and November 5, 2008 (i.e., during the October 31 to November 6, 2008 Rule 105 restricted period), Appaloosa Management sold short a total of 1,034,896 shares of common stock of Wells Fargo at prices ranging between $33.74 and $34.67 per share on behalf of Appaloosa Fund and Palomino Fund.

5. On November 5, 2008, following the close of the market, Wells Fargo announced a $10 billion public follow-on offering of common stock, which was priced on November 6, 2008. Appaloosa Management first learned of the Wells Fargo overnight offering at this time.

6. On November 6, 2008, Appaloosa Management, on behalf of Appaloosa Fund and Palomino Fund, purchased a total of 125,000 shares of Wells Fargo stock in the public offering at $27.00 per share. Appaloosa Management did not "cover" its short position in Wells Fargo stock with shares bought in the public offering. On November 13, 2008, Appaloosa Management sold the shares that it purchased in the offering for a profit of $53,750.

7. By virtue of its violation of Rule 105, Appaloosa Management made disgorgeable profits of $842,500 for the Funds.

8. As a result of the conduct described above, Appaloosa Management willfully[2] violated Rule 105 of Regulation M of the Exchange Act, which makes it "unlawful for any person to sell short ... [a] security that is the subject of [an] 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 … Rule 105 restricted period …."

Appaloosa Management's Remedial Efforts

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

Undertakings

Respondent undertakes to:

10. Continue to take steps to effect compliance with Rule 105 of Regulation M of the Exchange Act, which includes:

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[2] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

a. adopting, implementing and maintaining written compliance policies and procedures reasonably designed to prevent violations of Rule 105 of Regulation M of the Exchange Act and commencing in 2011, reviewing those policies and procedures annually;

b. providing training on Rule 105 of Regulation M to all new and existing employees and affiliates of Appaloosa Management who participate in or supervise trades or trading decisions;

c. requiring individuals executing any trade in a public offering (either on behalf of Appaloosa Management or its funds or other affiliated entities) to identify the trade and cause further review to ensure compliance with Rule 105 of Regulation M;

d. designating a senior level Appaloosa Management employee with responsibility for overseeing Appaloosa Management's compliance with Rule 105 of Regulation M and these undertakings; and

e. certifying in writing to the Commission no later than 30 days after the entry of this Order that it has adopted the policies and procedures described in Paragraph 10.a. above.

IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act and Section 203(e) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Appaloosa Management 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 Appaloosa Management is censured;

C. Respondent Appaloosa Management shall, within 14 days of the entry of this Order, pay (i) a civil money penalty of $421,250 and (ii) disgorgement of $842,500 and prejudgment interest of $40,773.34 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. § 3717. Payment shall be: (A) made by 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 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 Appaloosa Management as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Christopher R. Conte, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-5561; and

D. Respondent Appaloosa Management shall comply with the undertakings enumerated in Paragraph 10 above.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62448 / July 2, 2010

Admin. Proc. File No. 3-12918

In the Matter of

vFINANCE INVESTMENTS, INC.
and
RICHARD CAMPANELLA

c/o Carl F. Schoeppl, Esq.
Schoeppl & Burke, P.A.
4651 North Federal Highway
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Adam H. Smith, P.A.
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OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDING

CEASE-AND-DESIST PROCEEDING

Grounds for Remedial Action

Failure to Produce Records Promptly

Failure to Preserve Records

Aiding and Abetting Recordkeeping Violations

Broker-dealer willfully violated recordkeeping and production provisions of federal securities laws. Officer of broker-dealer willfully aided and abetted and was a cause of the violations. *Held*, it is in the public interest to censure broker-dealer and officer, to bar officer from associating in any supervisory or principal capacity with a right to reapply in two years, to impose cease-and-desist orders, and to impose civil money penalties.

APPEARANCES:

Carl F. Schoeppl, of Schoeppl & Burke, P.A., and *Adam H. Smith, P.A.*, for vFinance Investments, Inc. and Richard Campanella.

Marc J. Fagel, *John S. Yun*, and *Steven D. Buchholz*, for the Division of Enforcement.

Appeal filed: January 2, 2009
Last brief received: April 15, 2010
Oral argument: March 30, 2010

vFinance Investments, Inc., a registered broker-dealer ("vFinance" or the "Firm"), and Richard Campanella, the Firm's former chief compliance officer and later president (together with vFinance, "Respondents"), appeal an administrative law judge's decision.[1] The law judge found that vFinance willfully violated Section 17(a) of the Securities Exchange Act of 1934 and Exchange Act Rules 17a-4(b)(4) and 17a-4(j),[2] by failing to preserve and promptly produce electronic communications regarding its trading in the securities of Lexington Resources, Inc. ("Lexington"), and that Campanella willfully aided and abetted and was a cause of these violations. The law judge ordered Respondents to cease and desist, censured Campanella, and fined the Firm $100,000 and Campanella $30,000. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

I.

A. Background

During the period at issue, vFinance was based in Florida with approximately 120 registered representatives and about twenty-five branch offices.[3] From 2003 to July 2006,

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[1] *vFinance Invs., Inc.*, Initial Decision Rel. No. 360 (Nov. 7, 2008), 94 SEC Docket 11538.

[2] 15 U.S.C. § 78q(a)(1); 17 C.F.R. § 240.17a-4(a)(4) and (j).

[3] vFinance is a member of the Financial Industry Regulatory Authority, Inc. ("FINRA"), which was previously known as NASD. *See* Securities Exchange Act Rel. No. 56146 (July 26, 2007), 72 Fed. Reg. 42,190 (Aug. 1, 2007) (SR-NASD-2007-053) (approving NASD proposed rule change to reflect NASD's name change to FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc.).

(continued...)

Campanella was the Firm's chief compliance officer and was responsible for the Firm's preservation of business correspondence. Campanella also oversaw annual audits of the Firm's branch offices, conducted by a vFinance compliance auditor reporting directly to Campanella. Campanella was responsible for the procedures employed during these audits and reviewed the reports prepared by the compliance auditor after each audit. Campanella coordinated the timeliness and completeness of the Firm's production of any records requested by Commission staff. He often delegated responsibility for retrieving certain documents but retained responsibility for the completion of the Firm's record production.

Respondents were aware that the Firm's Exchange Act obligations to preserve and produce documents extended to electronic communications. The Firm's chairman testified that Firm policy prohibited personnel from using non-Firm e-mail accounts for business purposes because the Firm could not readily access or preserve such messages, and that Campanella was responsible for ensuring compliance with this policy. Branch office managers also signed a questionnaire during annual audits of the branches affirming that branch associated persons "us[ed] only vFinance['s] e-mail system for communicating [electronically] with the public."

Campanella also had responsibility for assuring that instant messages ("IMs") were saved in compliance with Firm policies. In July 2003, NASD issued a notice "urg[ing] [its] members to evaluate their internal use of instant messaging in light of their supervisory and recordkeeping requirements."[4] Campanella subsequently approved revised written policies requiring representatives to either disable IM programs on their computers or to keep paper copies of their IMs.

In spring 2004, Campanella received a copy of Commission Staff Legal Bulletin No. 17: Remote Office Supervision (the "2004 Bulletin"). The 2004 Bulletin reminded broker-dealers of their obligation to monitor representatives in small, remote branch offices, who may find it easier "to carry out and conceal violations of the securities laws;" recommended unannounced inspections of branch offices (but warned against "cookie cutter inspections"); and noted the responsibility of officers to "act decisively to detect and prevent" misconduct, particularly when confronted by indications of wrongdoing, *i.e.*, red flags.

Nicholas P. Thompson, a vFinance registered representative from June 2002 through August 2006, was the manager of the Firm's Flemington, New Jersey branch office. For most of the period at issue, the Flemington branch included only one other registered representative, Thompson's father. Thompson's trading activities were supervised from the Boca Raton office

[3] (...continued)
Because the events herein took place before NASD's name change, we continue to use the designation NASD.

[4] NASD Notice to Members 03-33 (July 2003).

by William Groeneveld, then vFinance's head trader. The Firm was entitled to 15% of the gross retail commissions generated by his branch office.

Thompson's association with vFinance was governed by an independent contractor agreement (the "IC Agreement"), which required Thompson to comply with Firm policies as well as all securities laws, rules, and regulations. Under the IC Agreement, Thompson agreed to "maintain . . . all required books and records for his retail securities business," and to submit to annual branch office audits. The IC Agreement also obligated Thompson to make his records available for review by the Commission and the Firm.

B. vFinance's Awareness of and Response to Thompson's Non-Compliance with its Electronic Communication Policies

vFinance audited the Flemington branch office in December 2003. The compliance auditor discovered that Thompson was communicating with Firm traders using IMs that were saved on his computer, *i.e.*, not in hard copy. Although he had authorized guidance in July 2003 requiring that IM programs be disabled or that the messages be kept in hard copy, Campanella approved Thompson's storage of IMs on his computer. During the audit, Thompson also signed the branch office manager questionnaire representing that he used only vFinance e-mail for public communications.

In January 2004, Campanella received a business-related e-mail message from Thompson that originated from a "blast.net" e-mail account. Recognizing that the message did not originate from Thompson's vFinance e-mail address, Campanella ordered Thompson to "[s]top using the above email." However, on February 3, Thompson again e-mailed Campanella from the blast.net account. Campanella responded: "We have discussed your email address on several occasions -- STOP using it -- next time I will hit you with a fine."

Campanella, however, did not discipline Thompson, even after receiving a third blast.net e-mail from Thompson regarding Firm business on March 8, 2004. Nor is there evidence that Campanella took any specific steps to monitor Thompson's subsequent use of the blast.net e-mail account. During the same period, Thompson continued to send blast.net messages regarding his orders and trading to other Firm personnel, most notably to Jonathan Matthai, who later became Campanella's compliance deputy.

When the Firm conducted an unannounced audit of Thompson's office in November 2004, neither Campanella nor anyone else at vFinance alerted the compliance auditor to Thompson's use of the blast.net account. The compliance auditor was not trained in detecting non-vFinance e-mail. He checked Thompson's desktop screen for an icon of a non-Firm e-mail account but did not find one. He did not make further checks for e-mail programs. His report directed Thompson to "continue[] to maintain the electronic file" of IMs and "contemporaneous notes of conversations with clients." Thompson once again affirmed that he used only the vFinance system to e-mail the public. As described below, Thompson sent Campanella a fourth blast.net message on September 17, 2005.

C. Red Flags Surrounding Thompson's Lexington Trading

Thompson was a Lexington market maker and represented retail clients trading in Lexington, including Liechtenstein-based Hypo-Alpe-Adria Bank ("Hypo"). Lexington was his most actively traded stock, generating him $274,334 in commissions and 578 trades between October 2003 and December 2005.

On May 12, 2004, NASD contacted Campanella to request vFinance's Lexington trading records in connection with an NASD investigation. On June 24, 2004, Groeneveld e-mailed Thompson about his Lexington trades (copying Campanella), cautioning Thompson that NASD rules regarding market manipulation were "becoming an issue." Groeneveld had discovered that vFinance had been responsible for 69% of Lexington trading for the first four months of 2004, and that the share price had steadily increased "from $4 to almost $7" from March to June 2004. Thompson agreed to limit his customers' Lexington purchase orders, and within the next five days, the share price fell from $7.50 to $3.50. Groeneveld could not explain the trading pattern but permitted Thompson to resume trading.

Groeneveld subsequently e-mailed Campanella that this pricing pattern "rais[ed] a red flag," because Lexington had "only $40,000 in revenue," the stock price increase "was orderly," and there were "numerous times when [Thompson] was both the inside bid and offer." Campanella reviewed the situation and responded to Groeneveld in September 2004 that he "looked at the trades and do not see any issues . . . go with your gut, and stop [Thompson] from trading the stock or you handle the trading for a few week[s] and then make a decision to stop trading the stock altogether." Thompson continued to trade Lexington.[5]

D. The Division's Requests for Lexington Records and vFinance's Response

By letter dated July 18, 2005, the Division contacted Campanella to request, among other things, "all paper and electronic materials related to" Lexington trading from October 1, 2003 to July 18, 2005 (the "Initial Covered Period"), including any "memoranda, correspondence, phone logs, and notes and recordings of conversations." The letter attached SEC Form 1661 ("Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena"), describing the Firm's obligations to produce records pursuant to Exchange Act Section 17(a).

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[5] Thompson was a respondent in this proceeding, charged with aiding and abetting the Firm's primary violations. He settled the Commission case against him without admitting or denying the charges. *vFinance Invs., Inc.*, Exchange Act Rel. No. 58403 (Aug. 21, 2008), 93 SEC Docket 8905, 8910 (imposing cease-and-desist order, $30,000 civil penalty, and associational bar with a right to reapply after five years).

Campanella assigned responsibility for the correspondence records to Thompson. On July 22, 2005, Thompson told Campanella: "I don't have anything to send you, but I would ask that all the correspondence between [Groeneveld] and I be included." Campanella responded to the Division's record request on August 2, 2005. Campanella identified Thompson as the Firm's registered representative responsible for Lexington trading. However, Campanella did not enclose any correspondence, stating that "[a]s per Mr. Thompson he does not have any correspondence, phone logs, notes or recordings of any conversations."[6] Campanella invited the Division to contact him for "any questions or need [for] additional information."[7]

The Division contacted Campanella on August 17 and 18, 2005, seeking confirmation that vFinance had searched Thompson's phone records. It also requested "access to all desktop and laptop computers used by Mr. Thompson during the [Initial Covered Period] for purposes of making forensic images of the hard drives," and Thompson's appearance for testimony.

Groeneveld took the lead in procuring the requested phone records, copying Campanella on his e-mails with Thompson. On August 19, Groeneveld ordered Thompson to produce phone records and Hypo contact information, ordering Thompson not to "accept any orders from [Hypo] until we get this information compiled." Thompson replied that he was sending most of the phone records that day and promised the remainder the next week.

On August 22, Groeneveld e-mailed Thompson that the Firm "would recommend that you seek independent counsel for any questions you may have regarding your personal property." Explaining this e-mail in investigative testimony, Groeneveld said that "the firm had taken the stance that, you know, they have to watch what they make independent contractors provide . . . ."

Thompson retained counsel and subsequently asked for a copy of the Firm's complete record production to the Division and for the return of phone records he had previously produced. Thompson complained to Groeneveld, copying Campanella, that he could not respond without these materials, and asserted that "[i]t is my understanding that by using the vFinance e-mail all my email are captured [in Boca Raton] and they are not my responsibility to keep them." Groeneveld copied Campanella on his September 1 response to Thompson, which stated:

> The firm definitely captures all emails, except the ones from a personal account like the [blast.net] account, and retains them to fulfill the firm's responsibility. If you choose not to retain them yourself as a branch manager and wish to rely upon the firm then that is your choice though you are required to retain the ones from your personal account.

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6 Some trading records were produced with this letter.

7 On August 11, 2005, vFinance sent the Division documents purporting to be "examples of our supervision of . . . Thompson."

On September 2, 2005, Campanella, Groeneveld, and Matthai (by then a member of the compliance department) spoke with the Division. Campanella's agenda for the call noted that the Division had specifically asked him whether all of the responsive e-mails had been produced, and whether Thompson's computer would be available for imaging as requested. On September 8, 2005, the Division again contacted Campanella about outstanding requests.

vFinance produced Thompson's phone records and Hypo contact information on September 12, 2005, but failed to confirm that it had searched Thompson's phone records as the Division had requested. Although the record does not suggest that Thompson had produced additional e-mails or IMs, Campanella relaxed the Hypo trading prohibition that day, authorizing Thompson to "start trading . . . with just purchases."

Five days later, Campanella received the fourth blast.net e-mail from Thompson described above. This message, sent two months after the Division's July 2005 record request, confirmed Thompson's continued use of the blast.net account for business purposes. Campanella responded by directing Thompson and an information technology ("IT") vice president to "get together . . . and start capturing his emails from this [blast.net] domain." Thompson assured Campanella: "This email is being closed, I paid until the end of the month and . . . I'm only going to have vFin email after this month." There is no evidence of compliance with Campanella's directive that IT work with Thompson to capture existing blast.net e-mails, or the imposition of any discipline on Thompson.

On September 22, 2005, Matthai sent the Division "Emails between Bill Groeneveld and Nick Thompson." After Thompson complained that the restrictions that remained on his trading were causing his "business [to] decline[] significantly," Groeneveld replied on September 27: "It[']s up to compliance now."

The next day, the compliance auditor again audited Thompson's branch office. Despite Respondents' knowledge of the Division's still-pending requests for Thompson's correspondence, and Thompson's recent attempt to disclaim responsibility for e-mail retention and production, the compliance auditor was not given a copy of the Division's request or directed to search for responsive documents. Even though Campanella had received another blast.net e-mail that same month, neither he nor anyone else at vFinance ever asked the compliance auditor to look at Thompson's blast.net account. During the audit, Thompson again represented that he used only "vFinance e-mail to communicate with the public." Although his audit notes suggest that the IT department may have been receiving the IMs by September 2005, the compliance auditor's report encouraged Thompson to "continue[] to maintain the electronic file of his [IM]s." Noting that the branch office "[r]egistered representatives maintain contemporaneous notes of their conversations with clients," the audit report advised the branch office to "encourage your representatives to continue to document these conversations in writing."

On October 5, 2005, the Division informed Thompson's counsel that "none of Mr. Thompson's correspondence with clients who traded in the stock of Lexington Resources ha[d] been produced." That day, Thompson's counsel sent the Division vFinance and blast.net e-mails from late March through late September 2005.[8] The blast.net account e-mails included vFinance business e-mails sent to persons outside the Firm. Campanella separately produced e-mails to the Division two days later. Campanella's cover letter stated that the production was "in response to [the Division's] correspondence" and that it enclosed "Emails for Lexington Resources, Inc.," but gave no further description of the e-mails or explanation for the three-month delay in producing them to the Division. Campanella's letter again invited the Division to contact him with any questions.

The Division documented its frustration with the Firm's unresponsiveness in a November 10, 2005 letter to Campanella, its fifth letter to Campanella (the "Division's November Letter"). In pertinent part, the letter stated:

> As I have discussed with you and your colleague Jon Matthai on numerous occasions, the staff is concerned that it has not received all communications of vFinance personnel during the requested period . . . . [I]t does not appear that all communications between vFinance personnel and clients regarding Lexington Resources have been produced, in particular email and instant message communications of Mr. Thompson . . . . As you know, Rule 17a-4(b)(4) requires vFinance to preserve communications for at least three years, the first two years in an easily accessible place.
>
> The staff requested these documents more than three months ago. Although vFinance represented on August 2, 2005 that Mr. Thompson does not have any correspondence relating to Lexington Resources, the staff later learned that Mr. Thompson in fact does possess responsive electronic communications that appear to be maintained in his vFinance office in New Jersey. In my letter of August 17, 2005, I requested that vFinance provide the staff access to computers used by Mr. Thompson to retrieve responsive electronic communications. To date, vFinance has not agreed to allow the staff . . . access to the computers.

The letter detailed deficiencies in the records that the Firm had produced, including e-mails produced without attachments and the absence of e-mails produced for April or July 2004. The Division requested certification of vFinance's "thorough search" and production of "all materials and information responsive to all staff requests."

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[8] It is unclear from the record whether Campanella knew about this production.

Matthai responded on behalf of vFinance on November 18, 2005 (the "Firm's November Response"). Matthai acknowledged the existence of Thompson's responsive "personal email correspondence involving Lexington":

> As previously discussed, Mr. Thompson is an Independent Contractor (IC) and the computers that he utilized are his personal property and not that of [vFinance]. The Independent Counsel for Mr. Thompson has advised him to not allow access to his personal computers. Mr. Thompson has represented . . . that he would search his personal email correspondence involving Lexington and make it available to the [C]ommission on November 21, 2005. It [is] the position of vFinance[] that Mr. Thompson should comply completely with all [SEC] requests . . . however personal email and personal computers are outside the control of vFinance.

The letter further stated, "To the best of our abilities vFinance Investments, Inc. certifies that it has conducted a search for all material and information responsive to all the staff[']s request."

On December 22, 2005, the Division contacted Matthai and Campanella to follow up with them about other records that had yet to be produced.

Campanella discussed the still-pending requests with the Division on January 5, 2006. The next day, he threatened Thompson with termination for failure to provide his "computer and emails." On January 10, 2006, nearly six months after the Division's initial request, Thompson's counsel produced another 244 pages of Thompson's e-mails, stating that Thompson had now produced "the complete set of the written communications between the parties that could be located." This production, like the October 2005 production, included extensive blast.net e-mails communicating with both clients and Firm personnel.

Weeks later, Thompson gave the Commission access to his hard drive for imaging. This imaging revealed that, as of February 14, 2006, Thompson's vFinance e-mail inbox contained only twenty-five "live" messages, *i.e.,* messages available without forensic recovery. Some of Thompson's messages were separately saved to an archive file on his hard drive. However, a forensic analysis found that Thompson began electronically searching for e-mail files related to Lexington about one week after the Firm disclaimed control over Thompson's "personal email and personal computers." He identified "at the very least approximately 1000 emails related to this matter," which were later deleted from the hard drive and then electronically "shredded," or made unrecoverable, in a multi-step process over a period of several months. In addition, approximately 850 of Thompson's e-mails between November 2005 and February 2006 were likely "double deleted" from Thompson's inbox and were only partially recoverable, even by forensic recovery.

The Division sent a document subpoena to vFinance on July 21, 2006, requesting the same communications as its July 2005 letter and extending the request from the Initial Covered

Period to 2006. On August 4, 2006, Thompson resigned. Meanwhile, Campanella was promoted to Firm president and chief executive officer, but continued to coordinate the Firm's subpoena response.

On January 18, 2007, the Division wrote vFinance:

> We understand that vFinance has never actually gone to Nick Thompson's office and searched for the documents requested by the staff. Instead, vFinance has relied on Mr. Thompson to respond to the staff's requests, despite the staff repeatedly informing vFinance that we had concerns about whether Mr. Thompson was making a good faith effort to search for and produce documents.

On January 31, 2007, vFinance agreed to provide "all emails sent by or to Nick Thompson, using his vFinance.com email address," but did not address the blast.net messages. That day, the Firm's IT department completed its search of the vFinance.com e-mail in about six hours. On February 5, 2007, vFinance produced Thompson's vFinance e-mails, but did not include attachments for messages before June 2005. Three days later, vFinance produced Thompson's August 2005 IMs showing extensive dialogue between Thompson and vFinance's traders regarding Firm business, but did not include Thompson's IMs for any of the Initial Covered Period.

Finally, in March 2007, almost eight months after the Division's subpoena, more than six months after Thompson's resignation, and approximately two months after the Division criticized the Firm's failure to search the office, Campanella searched the branch office for paper records. He found two boxes of responsive documents.

II.

Primary Liability: Firm's Failure to Preserve or Produce Section 17 Records

Exchange Act Section 17(a)(1) requires broker-dealers to make, keep, and furnish such records of its operations as the Commission, by rule, prescribes as necessary and appropriate in the public interest and for the protection of investors. Under Section 17(a) and Exchange Act Rule 17a-4, these requirements encompass business correspondence, including electronic communications such as e-mails and IMs with outside parties and within the broker-dealer.[9] The

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[9] *Reporting Requirements for Broker or Dealers Under the Securities Exchange Act of 1934*, Exchange Act Rel. No. 38245 (Feb. 12, 1997), 62 Fed. Reg. 6469, 6472 (noting that "the Commission believes that for record retention purposes under Rule 17a-4, the content of the electronic communication is determinative, and therefore broker-dealers must retain only those e-mail and Internet communications (including inter-office communications) which relate to the broker/dealer's 'business as such'").

content, rather than the format, of a message determines whether it is covered under Section 17(a).[10]

Commission access to the "basic source documents and transaction records"[11] is "a keystone of [our] surveillance of brokers and dealers."[12] We have stated, "[p]rompt access to a broker-dealer's books and records is fundamental to the Commission's ability to discharge its examination, investigative and law enforcement responsibilities."[13]

The Firm's production and preservation obligations covered all of Thompson's branch office's internal and external business electronic communications, including those sent or received from Thompson's vFinance account, his blast.net account or an instant messaging service. When Respondents received the Division's first request for records, they knew that Thompson used all of these electronic media to conduct Firm business.

A. Rule 17a-4(j): Failure to Produce Business Records Promptly

Exchange Act Rule 17a-4(j) requires broker-dealers to "furnish promptly" legible, true, and complete copies of records covered under Rule 17a-4 that are requested by the Commission.[14] We have stated that, "[g]enerally, requests for records which are readily available

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[10] *Id.*

[11] *Statement Regarding the Maintenance of Current Books and Records by Brokers and Dealers*, Exchange Act Rel. No. 10756 (Apr. 26, 1974), 4 SEC Docket 195.

[12] *Orlando Joseph Jett*, 57 S.E.C. 350, 396 (2004) (quoting *Edward J. Mawod & Co.*, 46 S.E.C. 865, 873 n.39 (1977), *aff'd*, 591 F.2d 588 (10th Cir. 1979)); *see also Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media Under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f)*, Exchange Act Rel. No. 44238 (May 1, 2001), 74 SEC Docket 2400, 2401 (noting that "preserved records are the primary means of monitoring compliance with applicable securities laws, including antifraud provisions and financial responsibility standards").

[13] *Banc of Am. Sec., LLC*, Exchange Act Rel. No. 49386 (Mar. 10, 2004), 82 SEC Docket 1372, 1380 & n.6 (settled proceeding) (citing S. Rep. No. 94-75, 94th Cong., 1st Sess. 120 (1975)).

[14] "The Commission's authority to access a broker-dealer's books and records is unconditional, subject only to the requirement that any such examination be reasonable." *Banc of Am.*, 82 SEC Docket at 1373. The reasonableness requirement "relates to time, place and manner of the examination and not to the scope thereof. . . . Any broader construction would undercut the

(continued...)

at the office (either on-site or electronically) should be filled on the day the request is made."[15] Moreover, a broker-dealer is "obligated to conduct its business in a manner that allow[s] it to furnish promptly required books and records upon demand from the Commission staff,"[16] and "[i]f a firm is ill-equipped to provide the full degree of cooperation necessitated by . . . an investigation . . . it has the obligation to act to correct that situation . . . . Failure to do so is certainly no defense."[17] Here, the Firm's production of records was neither prompt nor complete.[18]

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14 (...continued)
SEC's ability to perform its duties to effectively regulate the securities markets." *SEC v. J.W. Korth & Co.*, 991 F. Supp. 1468, 1472 (S.D. Fla. 1998).

15 *Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934*, Exchange Act Rel. No. 44992 (Oct. 26, 2001), 76 SEC Docket 432, 440; *see also Broker-Dealer Recordkeeping and Preservation Requirements*, Exchange Act Rel. No. 19190 (Dec. 10, 1982), 26 SEC Docket 840, 840 n.4 (Final Rule) ("*December 1982 Release*") (adopting Rule 17a-4(j) and explaining that "[i]n many, if not most, instances the rule generally will require the broker-dealer to turn over copies of the required records almost immediately").

16 *Dominick & Dominick, Inc.*, 50 S.E.C. 571, 580-81 (1991) (settled proceeding) (failure to preserve and furnish records resulting in broker-dealer cease-and-desist order, censure and undertakings; branch manager aiding and abetting and causing those violations barred in a supervisory capacity for five years and suspended from association with a broker-dealer for three months).

17 *Donald T. Sheldon*, 51 S.E.C. 59, 84 n.105 (1992), *aff'd*, 45 F.3d 1515 (11th Cir. 1995); *cf. Wedbush Sec., Inc.*, 48 S.E.C. 963, 972 (1988) (holding firm liable for delay when it could "have hired additional personnel, if necessary, either to assist in responding to the NASD's requests or to relieve others who could contribute more to that process").

18 At oral argument, the Division suggested that, where a market maker in a branch office is involved, a firm should be able to confirm that records sought have been preserved and to identify the location of records sought within thirty days of a request. We recognize that "[t]he time to turn over the records will . . . depend on the particular circumstances." *December 1982 Release*, 26 SEC Docket at 840 n.4. Here, however, the Firm was never able to confirm that all records sought had been preserved and had not identified the location of most records sought well after thirty days from the Division's July 2005 request; the Firm did not search Thompson's office until February 2007. *See Dominick*, 50 S.E.C. at 575 (eight-month delay in producing branch office records was not prompt); *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Exchange Act Rel. No. 53473 (Mar. 13, 2006), 87 SEC Docket 1870, 1871 & 1876 (settled proceeding) (seven-month delay in producing e-mails, including many from branch office, resulted in cease-and-desist order, censure, and $2.5 million total fine); *Banc of Am.*, 82 SEC Docket at 1376 &

(continued...)

Campanella's assignment of responsibility to Thompson to respond to the Division's request was questionable from the outset given Campanella's knowledge of the red flags surrounding Thompson's 2004 Lexington trading -- information indicative of a motive to withhold or obstruct production of relevant records. Respondents also knew of Thompson's repeated refusals to comply with Campanella's orders to stop using the blast.net account -- a pattern indicating Thompson's unwillingness to either act in accordance with recordkeeping requirements or to heed direct instructions from Campanella himself. Thompson's July 2005 assertion that he did not have any responsive records was implausible on its face in light of his extensive Lexington trading generating him almost $275,000 in commissions during a twenty-six month period. Nonetheless, Campanella's initial response to the Division cited Thompson's claim when Campanella failed to provide any responsive correspondence.

The inappropriateness of relying on Thompson became increasingly apparent. In September 2005, Campanella received the fourth blast.net message from Thompson, making clear that the account was still open. He also was copied on Thompson's attempts to disclaim responsibility for preserving his e-mails and to delay production of phone records. Campanella's production of e-mails in October 2005, three months after the Division's request, refuted Thompson's earlier claim that no responsive correspondence existed. The Division's November Letter documented the Firm's extensive response deficiencies.

Although the Division repeatedly complained to vFinance, Respondents allowed Thompson to delay production of his hard drive until February 2006, produced e-mails (most without attachments) and only one month of IMs in February 2007, and did not search the Flemington office for responsive hard copy records until March 2007. Respondents did not order a thorough search for all of Thompson's vFinance e-mails -- a search that ultimately took mere hours to execute -- until January 2007 (eighteen months after the July 2005 request). Respondents offer no credible justification for these delays.

The Firm's production of requested materials was never complete. For instance, Respondents produced only one month of IMs even though they knew that Thompson had been storing IMs on his computer since 2003. The Firm's January 2007 production of correspondence in response to the Division's subpoena covered only "emails sent by or to Nick Thompson, *using his vFinance.com email address*" (emphasis added). Moreover, despite the Firm's certification of completeness, e-mail attachments for the vast majority of those vFinance e-mails were missing. Deficiencies in the Firm's preservation of these records prevented the timely production of all of the requested materials, delay that Thompson used to destroy responsive records.

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[18] (...continued)
1383 (failure to retain and produce e-mails and other records for "nearly 2 years after the staff's original request" resulted in cease-and-desist order, censure and $10 million total fine).

Respondents nevertheless claim to have responded appropriately and in good faith. They assert that they were "alerted that Thompson was not cooperating with the SEC for the *first and only time* on January 5, 2006" (emphasis in original), and that the Division "staff never told any member of vFinance that they in fact did not get the computer" until January 2006. The Division's November Letter flatly contradicts these claims, documenting the Division's repeated requests. Moreover, the obligation to produce the documents rested with the Firm and could not be outsourced to Thompson.

We also disagree that Respondents showed good faith. From the outset, the Firm took the "stance that . . . they have to watch what they make independent contractors provide," encouraging Thompson to "seek independent counsel" and describing the computers in the branch office as his "personal property." However, we have long held the view "that the designation of an independent contractor has no relevance for purposes of the securities laws."[19]

The Firm's November Response claimed that vFinance was unable to produce Thompson's "personal emails and personal computers." Yet, the Firm was a party to the IC Agreement that obligated Thompson to make his records available to both the Firm and the Commission. Campanella acknowledged that the IC Agreement allowed the Firm access to Thompson's branch office records. The Firm in fact accessed Thompson's computer and other records during the September 2005 audit without ever directing the compliance auditor to retrieve responsive documents, hampering the Division's investigation.

Accordingly, we find that the Firm willfully failed to produce promptly Thompson's internal and external business correspondence, including blast.net messages and IMs, in violation of Exchange Act Section 17(a) and Rule 17a-4(j).

B. Rule 17a-4(b)(4): Failure to Preserve Communications in an Easily Accessible Place

Exchange Act Rule 17a-4(b)(4) requires each broker-dealer to "preserve for a period of not less than three years, the first two years in an easily accessible place . . . originals of all communications received and copies of all communications sent . . . (including inter-office

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[19] *Self-Regulatory Organizations: New York Stock Exchange, Inc.*, 71 Fed. Reg. 36,380, 36,382 & n.18 (June 26, 2006); *cf. Hollinger v. Tital Capital Corp.*, 914 F.2d 1564, 1574 (9th Cir. 1990) ("[W]e see no basis in the statutory scheme to distinguish between those associated persons who are employees and agents on the one hand, and those who are independent contractors on the other.") A broker-dealer "cannot permit its ability to supervise [its representatives] effectively to be negated or impeded by an 'independent contractor' whose right to engage in the securities business depends on affiliation with a registered firm charged with the duty to supervise." *Quest Capital Strategies, Inc.*, 55 S.E.C. 362, 372-73 (2001); *see also* Exchange Act Rule 17a-4(i), 17 C.F.R. § 240.17a-4(i) (stating that an "[a]greement with an outside entity" to maintain its books and records "shall not relieve such [broker-dealer] from the responsibility to prepare and maintain records as specified in" the rule).

memoranda and communications) relating to its business as such . . . ."[20] As discussed above, Respondents repeatedly asserted an inability to access Thompson's records directly. These assertions alone preclude a finding that such records were easily accessible within the meaning of the Exchange Act rule.[21] Moreover, Respondents authorized Thompson's storage of IMs electronically instead of in the required hard copy, acquiesced in the blast.net account although they knew the Firm was not capturing these e-mails, and failed to direct audits towards identifying and preserving these records.

Respondents argue that vFinance did not willfully violate Rule 17a-4(b)(4) because they "reasonably relied" on certifications, annual audits, and e-mail and IM policies to detect violative conduct, including the use of non-vFinance e-mail accounts. However, a broker-dealer cannot fulfill its regulatory recordkeeping obligations by failing to respond to known violations of such policies and regulatory requirements.[22] Respondents knew that Thompson was routinely using his blast.net account for Firm business, a fact more than sufficient to alert them to the possibility that the Firm was not capturing all of his business correspondence. Yet, because Respondents did not inform the compliance auditor about the blast.net account, his audits never focused on it.

Respondents argue that Campanella's "stern warnings" to Thompson about his blast.net usage demonstrate the Firm's commitment to recordkeeping. These "stern warnings" confirm Respondents' recognition that Thompson's was using blast.net messages for business correspondence. However, in spite of Thompson's refusal to heed Campanella's warnings, Campanella never imposed the threatened discipline on Thompson, nor implemented a system to preserve Thompson's business related blast.net messages.

The Firm also knew about, and Campanella expressly authorized, Thompson's storage of business-related IMs solely on his own computer beginning in 2003, although its own compliance policy required hard copy preservation. Moreover, electronic storage of these IMs violated the Exchange Act requirements unless they were "preserve[d] . . . exclusively in a non-

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[20] 17 C.F.R. § 240.17a-4(b)(4).

[21] *Cf. Dominick*, 50 S.E.C. at 580 (stating that Respondent that "itself contended that it was legally impossible to furnish the required records from Switzerland, cannot claim that the required books and records it chose to keep only in Switzerland were 'easily accessible'").

[22] *Cf., e.g., Houston A. Goddard*, 51 S.E.C. 668, 673 (1993) (finding that reliance on "regular firm procedures" without "respond[ing] to the increasing evidence of [representative's] unfitness" did not shield supervisor from violation of NASD rule); *Michael H. Hume*, 52 S.E.C. 243, 248-49 (1995) (finding that "mechanically fulfilling [a] checklist" cannot fulfill supervisory responsibility in light of known red flags regarding representative's conduct).

rewritable, non-erasable format" and available to the Commission at all times.[23] In authorizing Thompson's electronic storage of IMs, Campanella made no attempt to verify that they were in a non-erasable format, and subsequent events demonstrate that they were not.[24]

Accordingly, we find that vFinance willfully violated its Exchange Act Section 17(a) and Rule 17a-4(b)(4) obligation to preserve Thompson's electronic business correspondence in an easily accessible place.

C. Respondents' Arguments

Respondents claim that Thompson is responsible for the recordkeeping violations. They view the destruction of Thompson's computer files as the sole basis for these violations, going so far as to assert at oral argument that "Thompson is the person that's alleged to have been the primary violator here." Disclaiming "any knowledge of or . . . any role at all in Thompson's destructive acts," Respondents assert that they acted in good faith reliance on Firm policies and procedures.

Under Exchange Act Section 17(a), the broker-dealer has the primary responsibility for its business records. Accordingly, as the OIP alleged, the Division litigated, and the law judge found, the Firm is the primary violator in this case. The gravamen of these violations are the Firm's failures to preserve and produce the Firm's internal and external business-related correspondence. As demonstrated above, the Firm, acting through Campanella and others, engaged in a litany of violative conduct.

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[23] *See* 17 C.F.R. § 240.17a-4(f)(2)(ii)(A) and (f)(3)(i); *see also See Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media Under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f)*, Exchange Act Rel. No. 44238 (May 1, 2001), 74 SEC Docket 2400, 2405 ("*May 2001 Release*") ("[T]he Commission's regulatory function is undermined to the extent that these records are inaccurate, retained in a non-accessible manner, or capable of alteration. The Commission's enforcement record against unscrupulous broker-dealers that have changed or destroyed records demonstrates how such conduct can harm investors and the public interest.").

[24] Respondents further argue that the Firm's write-once-read-many ("WORM") drive was capturing any blast.net e-mails to vFinance accounts of the Firm's other employees. This assertion is contradicted by Groeneveld's September 2005 e-mail to Thompson, copied to Campanella, stating that "[t]he firm definitely captures all emails, except the ones from a personal account like the [blast.net] account." Campanella's directive to IT that they start collecting Thompson's blast.net e-mails further confirms that the Firm knew it was not collecting Thompson's blast.net e-mails.

Respondents cite the law judge's *respondeat superior* analysis, asserting that agency principles only apply in cases of customer loss, complaint or fraud. However, "[i]t is well-established that a firm may be held accountable for the misconduct of its associated persons because it is through such persons that a firm acts."[25] Thus, Section 15(b)(4) of the Exchange Act authorizes us to discipline a broker-dealer for proscribed conduct by "any person associated with such broker or dealer."[26] The statute makes no distinction between fraud and non-fraud based violations.

Here, Respondents assigned Thompson responsibility for record production. Despite abundant red flags and months-long delays in Thompson's production, they failed to assign anyone else to search his premises for responsive documents for over a year and a half. They previously had acquiesced in his storing IMs electronically and using a personal e-mail service for business. For these reasons, we reject Respondents' claim that Thompson "was acting totally for his own benefit and entirely outside the authorized scope of his relationship with vFinance."

Moreover, Campanella himself produced documents for the Firm in October 2005, three months after the Division's request. As of December 2005, Respondents had failed to produce requested trading reports. The Firm's production of additional responsive records in February 2007 was incomplete, lacking most e-mail attachments and Thompson's IMs. No explanation was ever given for these delays.

Respondents' claim of good faith is similarly misplaced. A finding of "[s]cienter is not required to violate Exchange Act Section 17(a)(1) and the rules thereunder."[27] Respondents cite

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[25] *SIG Specialists, Inc.*, Exchange Act Rel. No. 51867 (June 17, 2005), 85 SEC Docket 2679, 2692 & n.35; 15 U.S.C. § 78*o*(b)(4)(D); *see also SEC v. Wash. Invest. Network*, 475 F.3d 392, 393 (D.C. Cir. 2007) (noting that a corporation "could only act through its officers"); *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (1st Cir. 1977) (noting that a firm "can act only through its agents, and is accountable for the actions of its responsible officers"); *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 362 (6th Cir. 1970) (stating that it "has long been the position of the Commission that a broker-dealer may be sanctioned for the wilful violations of its agents under the doctrine of *respondeat superior*"); *see also Am. Soc'y of Mech. Eng'rs, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 566 (1982) (applying agency principles to antitrust law and stating that "a principal is liable for an agent's fraud though the agent acts solely to benefit himself, if the agent acts with apparent authority").

[26] 15 U.S.C. § 78*o*(b)(4).

[27] *E.g., Jett,* 57 S.E.C. at 396 (citing *SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 610 (S.D.N.Y. 1993), *aff'd sub nom. SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994), *cert. denied*, 513 U.S. 1077 (1995)).

the initial decision in *Raymond James Financial Services, Ltd.*[28] In that case the law judge declined to find a Section 17(a) violation for e-mail recordkeeping in light of contemporaneous Commission staff guidance indicating that, during the period at issue there (1999-2000), "Commission[] staff was (1) informing the industry that Rule 17a-4(b)(4) would be modified, and (2) requesting that NYSE not enforce the rule" because of ongoing discussion with respect to the available technology to preserve e-mail.[29] The recordkeeping failures in this case took place well after guidance was issued confirming the applicability of Rule 17a-4 to electronic correspondence.[30]

III.

Campanella's Aiding and Abetting Violations

Whether Campanella willfully aided and abetted the Firm's violations rests on whether (1) vFinance, in fact, committed the primary violations; (2) Campanella substantially assisted the conduct constituting the primary violations; and (3) Campanella provided that assistance with the requisite scienter.[31] The scienter requirement is satisfied if Campanella "knew of, or recklessly

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[28] Initial Decision Rel. No. 296 (Sept. 15, 2005), 86 SEC Docket 711, 782-83, *Finality Order*, Exchange Act Rel. No. 52810 (Nov. 21, 2005), 86 SEC Docket 2274.

[29] *Raymond James*, 86 SEC Docket at 782.

[30] *See May 2001 Release*, 74 SEC Docket 2400, 2401. Respondents also cite the good faith defense in Exchange Act Section 20(a). That section by its terms applies to allegations of control person liability, not to allegations of primary liability, or aiding and abetting or causing violations. 15 U.S.C. § 78t(a); *see generally SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1473 (2d Cir. 1996) (stating that, "[t]o meet the burden of establishing good faith, the controlling person must prove that he exercised due care in his supervision of the violator's activities in that he 'maintained and enforced a reasonable and proper system of supervision and internal controls'"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976) ("Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section.").

[31] *Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000); *see also Brendan E. Murray*, Investment Advisers Act Rel. No. 2809 (Nov. 21, 2008), 94 SEC Docket 11961, 11968; *Warwick Capital Mgmt., Inc.*, Advisers Act Rel. No. 2694 (Jan. 16, 2008), 92 SEC Docket 1410, 1421; *Phlo Corp.*, Exchange Act Rel. No. 55562 (Mar. 30, 2007), 90 SEC Docket 1089, 1103.

disregarded, the wrongdoing and [his] role in furthering it."[32] The preceding discussion establishes vFinance's primary violations.

A. Substantial Assistance

We find that Campanella substantially assisted the Firm's delays in producing records to the Division under Exchange Act Rule 17a-4(j). Campanella asked Thompson to search and then relayed to the Division Thompson's improbable claim that he had no responsive records. Campanella failed to alert the auditor to the Division's request during the September 2005 audit. That same month Campanella eased Thompson's Lexington trading restrictions, signaling the Firm's indifference to Thompson's failure to produce correspondence records. Campanella delayed threatening Thompson with any disciplinary consequences for this failure until January 2006. Campanella delayed any physical search of the Flemington branch office for twenty months from the date of the Division's initial record request, and well after these records had been subpoenaed.[33] Accordingly, we find that Campanella's conduct substantially assisted the Firm's failure to promptly produce the records to the Division.

Campanella also substantially assisted the Firm's failure to preserve the correspondence records. Campanella was responsible for the effectiveness and enforcement of the Firm's record retention policies. He oversaw the annual audits and had the authority to discipline Thompson for non-compliance with Firm or Commission rules. However, having known since at least January 2004 that Thompson used blast.net messages for business purposes, he failed to alert the compliance auditor to the existence of the blast.net account, did not order preservation of these communications until September 2005, and even then did not follow up on that order. He did not act on any of his repeated threats of discipline despite his knowledge of Thompson's continuing violations. Campanella's decision to authorize storage of IMs on Thompson's hard drive rather than in a non-writable, non-erasable format was a substantial causal factor in the Firm's failure to preserve Thompson's IMs in an easily accessible place and facilitated the destruction of records critical to a Division investigation.

Respondents describe Campanella's role as a mere failure to act, emphasizing that he did not assist in the destruction of documents. These claims misperceive the primary violations that Campanella aided and abetted, *i.e.*, failure to preserve and produce Firm documents. They also

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[32] *Phlo*, 90 SEC Docket at 1103 & n.49 (citing *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004)); *see also Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) ("A secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct."); *Graham*, 222 F.3d at 1000; *Geman v. SEC*, 334 F.3d 1183, 1195 (10th Cir. 2003) (upholding Commission determination that respondent "aided and abetted [books and records] violations with a state of mind of recklessness, if not willful disregard").

[33] *See Phlo*, 90 SEC Docket at 1105 (stating that "[p]ersons subject to Commission examination are not at liberty to set their own schedules for responding").

understate Campanella's role in them. In any event, we have frequently found aiding and abetting liability for a failure to act where, as here, the respondent has a clear duty to act and the failure to act itself constitutes the underlying primary violation.[34] Accordingly, we find that Campanella substantially assisted the Firm's violations of Exchange Act Section 17(a) and Rules 17a-4(j) and 17a-4(b)(4).

B. Scienter

Campanella also acted with the requisite scienter to establish aiding and abetting under Exchange Act Section 15(b). We find that Campanella's conduct, particularly given his status as chief compliance officer, was extremely reckless, and often knowing. He must have known of and ignored obvious risks and clearly knew of others. For example, he assigned Thompson responsibility for document production and had repeated indicia of Thompson's non-compliance. He received or was copied on correspondence establishing, and participated in telephone calls evidencing, red flags regarding the Firm's and Thompson's record preservation and production that Campanella recklessly disregarded. Moreover, Campanella personally approved the storage of IMs on Thompson's computer in violation of Commission rules and Firm policy.

Campanella contends that the appropriate standard for scienter is "actual knowledge." He focuses on the scienter standard under Exchange Act Section 20(e).[35] However, Section 20(e) applies to cases brought in federal district court for "knowingly provid[ing] substantial

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[34] *See Marc N. Geman*, 54 S.E.C. 1226, 1258-59 (2001) (finding that officer willfully aided and abetted firm's recordkeeping violations by his "inaction, which was at the very least reckless" because he was "an active 'hands-on' manager" who remained responsible for firm's recordkeeping despite his attempts to delegate responsibility), *aff'd*, 334 F.3d 1183, 1195 (11th Cir. 2003); *Phlo*, 90 SEC Docket at 1105 & 1118-19 (finding vice president and general counsel charged with responding to the Commission, "rendered substantial assistance" to firm's Exchange Act Section 17(b)(1) violation "by her delays in responding and by ultimately submitting incomplete responses" to Commission staff; revoking transfer agent registration, and barring senior officer from association with a registered transfer agent and assessing $100,000 for aiding and abetting violations of turnaround rule and failure to produce records); *Zion Capital Mgmt., LLC*, 57 S.E.C. 99, 116 (2003) (holding that president aided and abetted firm's recordkeeping violations because he failed to "retain his contemporaneous trading notes" and "copies of [his] written communications" as required by Advisers Act).

[35] 15 U.S.C. §§ 78t(e), 78u(d)(1) & (3). For instance, Respondents cite cases brought under 20(e) as establishing a requirement that the respondent "[c]onsciously intended to assist in the perpetration of a wrongful act." Quoting *SEC v. Pasternak*, 561 F. Supp. 2d 459, 502 (D.N.J. 2008).

assistance" to securities law violations.[36] In Commission administrative proceedings under Exchange Act Section 15(b), recklessness is sufficient to establish aiding and abetting liability, and here we find Campanella's conduct was variously knowing and extremely reckless.[37]

He further asserts that the "willfulness" standard applied in administrative proceedings "implicitly connotes actual knowledge rather than recklessness."[38] Willfulness in this context means "intentionally committing the act which constitutes the violation" but does not require knowledge that such actions constitute a rule or statutory violation.[39] Accordingly, we find that Campanella willfully aided and abetted the Firm's primary violations of Exchange Act Section 17(a) and Rules 17a-4(b)(4) and 17a-4(j), and that he was a cause of these violations.[40]

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[36] Exchange Act § 20(e), 15 U.S.C. § 78t(e) (limiting its scope to "any action brought by the Commission under paragraph (1) or (3) of section 21(d)"); Exchange Act § 21(d)(1) & (3), 15 U.S.C. § 78u(d)(1) & (3) (describing standards for injunctions and for money penalties in United States district court). At oral argument, Respondents also asserted that the "standard for liability should be the same, regardless of the forum, regardless of the nature of the proceeding," but have not provided authority or analysis in support of this proposition. As the Division pointed out, the different scienter requirements for aiding and abetting liability under Sections 20(e) and 15 are consistent with differing scope of the respective sections.

[37] *SEC v. Johnson,* 530 F. Supp. 2d 325, 332-34 (D.D.C. 2008) (noting that the "willful" standard applied in administrative hearings "is less burdensome than the 'knowingly' standard imposed by Congress in Section 20(e)") (citations omitted); *Ponce v. SEC,* 345 F.3d 722, 737-38 (9th Cir. 2003) (upholding Commission's determination that respondent aided and abetted filing of false periodic reports because he "had knowledge, or at least was reckless in not recognizing, the misleading nature of the statements," and "played an essential and integral part of the" reporting and recordkeeping responsibilities); *Graham,* 222 F.3d at 1004-06 ("We have held that knowledge or recklessness is sufficient to satisfy [the scienter] requirement.").

[38] In their reply brief, Respondents argue for the first time that the "applicable legal standards are so 'muddied' that even the courts are unable to discern a uniform code of conduct," making it unfair to find liability. Respondents' citation of cases addressing the scienter standard under Exchange Act Section 20(e), however, does not suggest confusion regarding the scienter standard for aiding and abetting liability under Section 15.

[39] *Wonsover v. SEC,* 205 F.3d 408, 414 (D.C. Cir. 2000).

[40] Respondents argue that Campanella could not be found to be a cause of the violations when he did not have "actual knowledge of wrongdoing." The statute, however, defines "cause" as an "an act or omission the person know or should have known would contribute to" a violation. 15 U.S.C. § 78u-3(a). The record evidence establishes both that

(continued...)

IV.

Sanctions

The law judge censured Campanella, ordered Respondents to cease and desist, and fined the Firm $100,000 and Campanella $30,000. In granting Respondents' petition for review, we determined on our own motion to review "what sanctions, if any, are appropriate in this matter," and on April 1, 2010, we issued an order directing the filing of additional briefs addressing sanctions.[41] As we have previously observed, "[w]hen Congress grants an agency the responsibility to impose sanctions to achieve the purpose of a statute, 'the relation of remedy to policy is peculiarly a matter for administrative competence.'"[42] Respondents characterize the sanctions imposed by the law judge as "disproportionate and overly severe." We disagree.

A. Censure and Associational Bar

Exchange Act Sections 15(b)(4) and 15(b)(6) authorize us to censure, place limitations on, suspend, or revoke the registration of any broker-dealer, or bar a person associated with a broker-dealer[43] if we find conduct willfully violating or aiding and abetting a violation of the securities laws, and that such sanction is in the public interest.[44] In determining whether a sanction is in the public interest under Section 15(b), we consider such factors as: the egregiousness of respondent's actions; the isolated or recurrent nature of the infraction; the degree of scienter involved; the sincerity of respondent's assurances against future violations; the respondent's recognition of the wrongful nature of his conduct; and the likelihood that respondent's occupation will present opportunities for future violations.[45]

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40 (...continued)
Campanella knew and certainly should have known that his actions would exacerbate the violations in this case.

41 *Order Granting Petition for Review* (Jan. 6, 2009), Admin. Proc. File. No. 3-12918; *Order Directing Filing of Additional Briefs* (Apr. 1, 2010), Admin. Proc. File. No. 3-12918.

42 *See Leslie A. Arouh*, 57 S.E.C. 1099, 1119 & n. 44 (2004) (quoting *Butz v. Glover Livestock Comm'n Co., Inc.*, 411 U.S. 182, 185 (1973) (internal citations omitted)).

43 15 U.S.C. § 78*o*(b)(4); (b)(6)(A).

44 15 U.S.C. § 78*o*(b)(4)(D); (b)(6)(A) and (b)(4)(E).

45 *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979).

We have made clear that "the failure to cooperate with a [Commission] examination is serious misconduct that justifies strong sanctions because of its potential to thwart the protection of shareholders and market participants."[46] A bar serves a remedial purpose of protecting investors from persons who have refused to cooperate with investigations of possible securities law violations, and deters other securities participants subject to regulatory investigations from engaging in similar conduct. Securities professionals should be incentivized to cooperate with regulatory investigations such that the sanction for a failure to produce documents or information are likely to be greater than, or at least comparable to, the potential sanction for any wrongdoing that might be uncovered during such investigation.[47]

Respondents' conduct was egregious. Rather than prioritizing compliance, Respondents authorized lapses in recordkeeping, engaged in dilatory tactics stalling production, and disregarded clear red flags demonstrating the impropriety of their reliance on Thompson to preserve and produce records. Respondents' Exchange Act violations ultimately facilitated the destruction of the only version of certain records critical to a Commission fraud investigation.

The violations were not isolated. The Rule 17a-4(b)(4) violations continued for several years after Respondents were first alerted to the deficiencies in the Firm's preservation of blast.net messages and IMs in 2004, and the Rule 17a-4(j) violations persisted for almost two years after the Division's July 2005 record request. Although the Firm's primary liability under Section 17(a) need not be based on a scienter finding, the evidence that Respondents knew about the conduct constituting the violations and recklessly disregarded their regulatory obligations weigh in favor of meaningful remedial sanctions.

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[46] *Phlo,* 90 SEC Docket at 1110 (barring officer for aiding and abetting company's violations of turnaround rule and for failing to provide records to Commission until after it commenced an investigation); *see also Schield Mgmt. Co.*, Exchange Act Rel. No. 53201 (Jan. 31, 2006), 87 SEC Docket 848, 862 (barring former president, based on injunction, for failing to keep required records and make them available to Commission staff; stating that "the failure to cooperate with a Commission examination constitutes 'serious misconduct' justifying strong sanctions" (citing *Barr Fin. Group, Inc.*, 56 S.E.C. 1243, 1262 (2003))); *Gary M. Kornman*, Exchange Act Rel. No. 59403 (Feb. 13, 2009), 95 SEC Docket 14246, 14247 (barring associated person in a follow-on proceeding for criminal conviction for a false statement during a Commission investigation), *petition denied*, 592 F.3d 173 (D.C. Cir. 2010).

[47] *See, e.g.*, *PAZ Sec., Inc.*, Exchange Act Rel. No. 57656 (Apr. 11, 2008), 93 SEC Docket 5122, 5128 ("The possibility of receiving a bar for a failure to cooperate may have a very specific deterrent effect on all current and future SRO members and associated persons. NASD members and associated persons who know of wrongdoing and are approached by NASD with requests for information as part of an investigation should be deprived of any incentive to fail to cooperate."); *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005) (noting that "the SEC has expressly adopted deterrence, both specific and general, as a component in analyzing the remedial efficacy of sanctions").

Respondents neither offer assurances against future violations nor recognize the wrongfulness of their conduct. Rather, throughout the proceeding, Respondents have attempted to shift all responsibility to Thompson, and to hide behind policies and procedures that the Firm and Campanella failed to enforce. As we have stated, "attempts to shift blame are additional indicia of [a respondent's] failure to take responsibility for his actions."[48] This pattern further underscores the risk that Respondents will continue to engage in similar misconduct and, together with the above factors, indicates a strong likelihood of future violations.[49]

Given these circumstances, we believe the public interest supports barring Campanella from associating with a broker-dealer in any supervisory or principal capacity with a right to reapply in two years. This limited bar is tailored to serve the specific remedial purpose of discouraging Campanella, who aided and abetted Exchange Act violations while serving as chief compliance officer and later as president, from repeating similar misconduct in the future.

Based on the foregoing, we also find it appropriate and in the public interest to censure both vFinance and Campanella. In this regard, we note the Firm's recent disciplinary history, including 2005 and 2008 settlement of Commission charges of failures to reasonably supervise

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48 *Clyde J. Bruff*, 53 S.E.C. 880, 887 (1998).

49 We have emphasized repeatedly that the obligation to provide information to regulatory authority is so critical to the functioning of the regulatory system that violations such as Respondents' can only be adequately addressed by meaningful sanctions. For example, we have often sustained SRO decisions to expel firms from membership and to bar individuals from association for complete failures to provide requested information and dilatory tactics like those engaged in here. *See, e.g., PAZ*, 93 SEC Docket at 5127 (sustaining expulsion of NASD member firm and bar of its president for failing to respond to information requests where there were no mitigating circumstances; stating that "[d]elay and neglect" in response to information requests undermines a regulator's ability "to conduct investigations and thereby protect the public interest"), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009); *Toni Valentino*, 57 S.E.C. 330, 339 (finding "attempts to delay and ultimately avoid . . . appearance are especially troubling given the importance of" NASD investigation rule).

In explaining the rationale for strong sanctions, we have agreed with the judgement of SROs that misconduct by individuals responsible for providing information to the SRO "renders the violator presumptively unfit for employment in the securities industry." *PAZ*, 93 SEC Docket at 5126; *see also Geoffrey Ortiz*, Exchange Act Rel. No. 58416 (Aug. 22, 2008), 93 SEC Docket 8977, 8989 (observing "that [NASD's] ability to request and obtain information from its members and associated persons is crucial to NASD's performance of its regulatory mission, and that the complete failure to respond to such requests is 'fundamentally incompatible' with that mission").

sales of unregistered stock and market manipulation, respectively.[50] As we have stated, "repeated violations indicate the need for sanctions severe enough to deter further misconduct, and to impress . . . the need for scrupulous compliance in the future."[51]

Respondents' primary challenge to sanctions is based on their claim of ignorance of Thompson's dilatoriness. As noted above, the Division reminded Respondents early and often that its request for Thompson's correspondence remained outstanding.

Respondents also complain there was "no indication that the Division's request was in connection with anything other than a routine investigation -- the Division did not express urgency." Exchange Act Rule 17a-4(j) does not differentiate between "routine" and "urgent" record requests. It requires broker-dealers to "furnish promptly" required records upon request by Commission staff, and the onus for ensuring prompt compliance falls on the broker-dealer, not the Division. In any event, Respondents' claim is unfounded. Record evidence establishes Respondents' knowledge of possible market manipulation activities in connection with Thompson's Lexington trading beginning as early as NASD's May 2004 document request. As early as August 2005, the Division had expressed concern with the Firm's responsiveness to its July request.

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[50] *vFinance*, Exchange Act Rel. No. 57727 (Apr. 28, 2008), 93 SEC Docket 5465, 5470-72 (ordering censure, $19,787 disgorgement, and undertakings, among other things, to retain an independent consultant to review the Firm's supervisory procedures "regarding its compliance with Section 5 of the Securities Act"); *vFinance*, Exchange Act Rel. No. 51530 (Apr. 12, 2005), 85 SEC Docket 742, 744-45 (ordering censure, $50,000 penalty, and undertakings, among other things, to retain an independent consultant to review the Firm's supervisory procedures and recommend changes "to prevent and detect manipulative activity by traders").

These settlements belie Respondents' claim that an asserted lack of disciplinary history obviates the need for sanctions. The 2005 settlement was entered while Campanella was chief compliance officer and before the Division's first July 2005 request for Lexington records. Campanella was at least on notice of problems in the Firm's compliance culture when he received the record request. In any case, we have stated that "the absence of disciplinary history is not mitigative as securities professionals should not be rewarded for complying with securities laws." *Mitchell M. Maynard*, Advisers Act Rel. No. 2875 (May 15, 2009), 95 SEC Docket 16844, 6860 & n.39 (citation omitted) (barring associated person in follow-on proceeding for state antifraud violations); *see also Siegel v. SEC*, 592 F.3d 147, 157 (D.C. Cir. 2010); *Rooms v. SEC*, 444 F.3d 1208, 1214-15 (10th Cir. 2006).

[51] *Lowell H. Listrom*, 48 S.E.C. 609, 613 (1986); *see also Schield Mgmt. Co.*, 87 SEC Docket at 864 ("We note further that this is not the first time that Respondents have been subject to disciplinary proceedings.").

Respondents argue that severe sanctions are not warranted in the "absence of any specifically delineated standards or actions that a broker-dealer such as vFinance could take to respond to a Division request." However, as noted above, we have issued several statements delineating the standards for the violations here. The authorities we have cited are ample to put Respondents on notice that the conduct at issue here was not compliant.

Respondents' failure to acknowledge the plain language of the rule and this body of authority interpreting these standards is particularly disturbing. A chief compliance officer and president of a registered broker-dealer must possess a thorough grasp of the firm's regulatory requirements,[52] and during its investigation the Division repeatedly reminded Respondents of the Firm's obligations to preserve records in an "easily accessible place" and to "promptly produce" these records under the Exchange Act rules. Respondents' claims of unfamiliarity with applicable standards suggest an indifference to fundamental broker-dealer obligations presenting a serious risk of future violations and threat to the public interest that we believe can only be ameliorated by the censure of Respondents and limited bar on Campanella discussed above.[53]

B. Cease-and-Desist Orders

Exchange Act Section 21C(a) authorizes the Commission to impose a cease-and-desist order upon any person who "is violating, has violated, or is about to violate" any provision of the Exchange Act or any rule or regulation thereunder, or against any person who "is, was, or would be a cause of [a] violation, due to an act or omission the person knew or should have known would contribute to such violation."[54] In our public interest analysis for cease-and-desist orders, we assess, in addition to the above factors, "whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served

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[52] *See* NASD Conduct Rule 3013 (adopted Dec. 1, 2004), NASD Manual at 4374 (2006 ed.) (now codified in FINRA Rule 3130.05) (stating "[t]he chief compliance officer is the primary advisor to the member on its overall compliance scheme and the particularized rules, policies, and procedures that the member adopts"); *see also Thomas F. White*, 51 S.E.C. 1194, 1197 (1993) ("As the firm's chief compliance officer, [a non-respondent] also shouldered the bulk of the responsibility for ensuring that the firm's salesmen complied with applicable requirements.").

[53] *See Schield Mgmt. Co.*, 87 SEC Docket at 866 (stating that respondents' failures to cooperate with a Commission examination "demonstrate[] either that [they] fundamentally misunderstand the regulatory obligations to which they are subject or that they hold those obligations in contempt" (internal punctuation omitted) (quoting *Barr Fin.*, 56 S.E.C. at 1261-62)).

[54] 15 U.S.C. § 78u-3(a).

by the cease-and-desist order in the context of any other sanctions."[55] We believe that cease-and-desist orders are appropriate in this case.

As discussed above, the violations in this case were recent and recurrent, continuing through at least March 2007. Respondents had ample opportunity to correct blatant deficiencies in the Firm's recordkeeping and delays in its production. Instead, Respondents compounded these deficiencies and delays by falsely asserting that Thompson's status as an independent contractor prevented them from accessing the branch office records -- even after they actually accessed these records in September 2005 without searching for responsive documents.

The absence from the record of evidence demonstrating any direct customer harm is not mitigating, as our public interest analysis "focus[es] . . . on the welfare of investors generally."[56] In reviewing failures to produce information to SROs, we have observed that such a failure

> will rarely, in itself, result in direct harm to a customer. Rather, failing to respond undermines [the regulator's] ability to detect misconduct that may . . . have resulted in harm to investors or financial gain to respondents. Thus, even if the failure to respond does not result in direct improper financial benefit to respondents or harm to investors, it is serious because it impedes detection of such violative conduct.[57]

Cease-and-desist orders here serve the additional remedial function of encouraging future compliance with record preservation obligations and prompt responses to record production requests. Respondents give no indication of a desire to leave the industry, and as previously noted, such continued participation in the industry will present them with future opportunities for similar violations.

Respondents contend that Campanella is no longer associated with vFinance and that it is "unlikely that the precise situation will arise again in the future," thereby eliminating the risk that Respondents would commit future violations. We disagree. Our examination and investigative staffs routinely request records as part of our core mission to protect investors, deter, detect, and prosecute violative conduct, and monitor developments in the industry. Broker-dealers and their associated persons have ongoing obligations to maintain, preserve, and produce accurate records. We believe a cease-and-desist order will reinforce the importance of our record-keeping requirements. A cease-and-desist order against Campanella is appropriate because he may have future opportunities for similar violations if he acts in a supervisory or principal capacity after the

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[55] *KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1192 (2001), *petition denied*, 289 F.3d 109 (D.C. Cir. 2002).

[56] *Kornman*, 95 SEC Docket at 14259; *see also Graham*, 222 F.3d at 1001 n.15 (stating that "unlike a . . . private damages action, the SEC need not prove actual harm").

[57] *Paz*, 93 SEC Docket at 5129.

two-year bar has elapsed, and/or if he associates in any other capacity with a broker-dealer while the limited bar is in effect.[58]

C. Civil Penalties

Under Exchange Act Section 21B, we may impose civil monetary penalties when a respondent has willfully violated or aided and abetted Exchange Act violations, and such penalties are in the public interest.[59] The public interest considerations under Section 21B(c) include (1) whether the violation involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement, (2) the direct or indirect harm to other persons, (3) any unjust enrichment, (4) any prior record of violations by the Commission, other regulatory agencies or SROs, (5) the need to deter the respondent or respondents and other persons from committing similar misconduct, and (6) such other matters as justice may require.[60] Section 21B establishes a three-tier system for calculating the maximum penalty. For each act or omission involving deliberate or reckless disregard of a regulatory requirement occurring after February 14, 2005, a second-tier civil penalty may be assessed in maximum amounts of $325,000 against a corporation or $65,000 against an individual.[61]

Respondents' knowledge and recklessness with respect to the repeated and longstanding violations, in light of the other recent charges against the Firm, demonstrate a pernicious pattern of non-compliance that continued at the Firm until 2007. These considerations call for meaningful monetary penalties to encourage Respondents to prioritize compliance with Section

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58 In disputing the propriety of cease-and-desist orders in this case, Respondents cite *WHX Corp. v. SEC*, 362 F.3d 854 (D.C. Cir. 2004), which vacated a Commission cease-and-desist order. The rationale for *WHX* is inapplicable here. In contrast to this case, *WHX* involved "a single, isolated violation" that was voluntarily and expeditiously corrected upon notification by Commission staff, suggesting a *de minimus* risk of recurrence. *Id.* at 861.

59 15 U.S.C. § 78u-2(a)(1); (a)(2).

60 Exchange Act Section 21B(c), 15 U.S.C. § 78u-2(c).

61 *See Debt Collection Improvement Act of 1996*, Pub. L. No. 104-134, 110 Stat. 1321-373 (1996) (codified at 28 U.S.C. § 2461); 17 C.F.R. § 201.1002.

17(a) rules.[62] We find that Respondents' reckless disregard of these regulatory requirements merit second-tier penalties.

Accordingly, we have assessed one $50,000 penalty against the Firm and one $15,000 penalty against Campanella for each of the two Exchange Act rules violated, for total penalties of $100,000 and $30,000 respectively.[63] In determining the penalty amounts, we have taken into consideration the likelihood of future violations and the other sanctions imposed in this case, including Campanella's limited two-year bar. We find these penalties warranted to create a monetary incentive for Respondents and other industry participants to fulfill their recordkeeping obligations and cooperate with regulatory inquiries -- particularly when, as in this case, such person is aware that compliance may reveal regulatory violations potentially resulting in disgorgement or monetary penalties.[64] With respect to the Firm, the base $50,000 penalty amount is greater than the Firm's estimated share of the remuneration for Thompson's Lexington trading, which record evidence suggests was approximately $48,412 from October 2003 through December 2005.[65] With respect to Campanella, we believe that a base $15,000 penalty amount

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[62] *See The Securities Law Enforcement Remedies Act of 1990*, S. REP. NO. 101-337, at 11 (1990) ("For some firms, a censure may provide relatively little deterrence against future violations. However, revocation of a firm's registration or temporary suspension of its operations could impose hardship on a firm's customers, public shareholders, and innocent employees. With the option of imposing a monetary penalty, the SEC may appropriately sanction a violation requiring a penalty more severe than censure, but without the adverse consequences of a suspension or revocation.").

[63] *Cf. Mark David Anderson*, Exchange Act Rel. No. 48352 (August 15, 2003), 80 SEC Docket 3250, 3270 (assessing separate penalty for each of 96 violative trades).

[64] *See* S. REP. NO. 101-337, at 15, 10, 11 (1990) (noting that the "effectiveness of deterrence may be a function of the economic gain to be derived from a violation and the probability that a violation will be detected," and that "[t]o the extent that violations . . . are motivated by a desire to maximize profits by reducing costs, the possibility of civil money penalties will improve compliance . . . and have a significant remedial effect").

[65] Record evidence produced by the Firm indicates that Thompson received approximately $274,334 in commissions for his Lexington trading during this period. The Firm was entitled to retain 15% of the gross commissions generated by Thompson under the IC agreement, suggesting that Thompson's Lexington trading had generated gross commissions of approximately $322,746, and that the Firm retained $48,412 of this amount.

appropriately reflects his knowledge, recklessness and responsibility for the Firm's recordkeeping policies and its responses to the Commission record requests.[66]

An appropriate order will issue.[67]

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

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[66] *See* S. REP. NO. 101-337, at 10 (noting that penalties are appropriate for violations such as bookkeeping violations that "may reflect an unwillingness to incur the cost of full compliance with the securities laws" that may expose investors "to significant risk of loss, even though the violations may not involve affirmative conduct to defraud investors").

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

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62448/July 2, 2010

Admin. Proc. File No. 3-12918

In the Matter of

vFINANCE INVESTMENTS, INC.
and
RICHARD CAMPANELLA

c/o Carl F. Schoeppl, Esq.
Schoeppl & Burke, P.A.
4651 North Federal Highway
Boca Raton, FL 33431-5133

Adam H. Smith, P.A.
2650 N. Military Trail, Suite 125
Boca Raton, FL 33432

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that vFinance Investments, Inc. be, and it hereby is, censured; and it is further

ORDERED that vFinance Investments, Inc. cease and desist from committing or being a cause of any violations or future violations of Section 17(a) of the Securities Exchange Act of 1934 and Rules 17a-4(b)(4) and 17a-4(j) by failing to preserve or produce required records; and it is further

ORDERED that vFinance Investments, Inc. pay a civil money penalty in the amount of $100,000; and it is further

ORDERED that Richard Campanella be, and he hereby is, censured and barred from association with any broker or dealer in any principal or supervisory capacity with a right to reapply after two years; and it is further

ORDERED that Richard Campanella cease and desist from committing or being a cause of any violations or future violations of Section 17(a) of the Securities Exchange Act of 1934 and Rules 17a-4(b)(4) and 17a-4(j) by failing to preserve or produce required records; and it is further

ORDERED that Richard Campanella pay a civil money penalty in the amount of $30,000.

Payment of the civil money penalties shall be: (i) made by United States postal money order, certified check, bank cashier's check, or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) mailed or delivered by hand to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312; and (iv) submitted under cover letter that identifies the respondent and the file number of this proceeding. A copy of the cover letter and check shall be sent to John S. Yun, 44 Montgomery Street, Suite 2600, San Francisco, CA 94104.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter
not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62460 / July 7, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13958

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

I.

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

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

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

II.

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

III.

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

1. Santarlas, age 33, is a resident of Hoboken, New Jersey.

2. Santarlas is and has been an attorney licensed to practice in the State of New York. Santarlas joined the law firm of Ropes & Gray LLP as an associate in 2005 where he continued to work as an associate until his resignation in September 2008.

3. On July 2, 2010, a final judgment was entered by consent against Santarlas, permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, in the civil action entitled *Securities and Exchange Commission v. Brien Santarlas*, Civil Action No. 09-CV-10100 (RJS), filed in the United States District Court for the Southern District of New York. The final judgment also ordered Santarlas to pay disgorgement and a civil penalty.

4. The Commission's complaint alleged, *inter alia*, that Santarlas, as an attorney at Ropes & Gray, had access to, and learned of, material nonpublic information concerning corporate acquisitions in which Ropes & Gray represented acquirers or bidders in proposed acquisitions. The complaint further alleged that, in 2007, Santarlas and others entered into a scheme to trade on material, nonpublic information concerning upcoming corporate acquisitions involving Ropes & Gray's clients. The Commission's complaint also alleged that, as part of this scheme, and in breach of his fiduciary and other duties of trust and confidence owed to Ropes & Gray and its clients, Santarlas misappropriated and illegally tipped material, nonpublic acquisition information to others concerning the 2007 announced acquisitions of 3Com Corp. and Axcan Pharma Inc. Additionally, the complaint alleged that others traded on the basis of this information and that, in exchange for tipping the information, Santarlas received cash kickbacks.

IV.

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

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

Santarlas is suspended from appearing or practicing before the Commission as an attorney.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes
not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62465 / July 7, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3150 / July 7, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13959

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

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III. C. below, which are admitted,

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

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

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

III.

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

A. Ilse Cappel, age 47, was at all relevant times a certified public accountant licensed to practice in the state of California, on inactive status. She was employed at Peregrine Systems, Inc. from 1993 until June 2002, and held various positions, including Senior Treasury Manager and Assistant Treasurer.

B. Peregrine Systems, Inc. ("Peregrine") was, at the time of Cappel's employment, a Delaware corporation with principal offices in San Diego, California. Peregrine's primary business involved selling infrastructure management software. From its initial public offering in April 1997, until it merged with Hewlett-Packard in 2005, Peregrine's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). It traded on the Nasdaq National Market System from its initial public offering until August 30, 2002, when it was delisted and quoted on the Pink Sheets. In February 2003, Peregrine announced the restatement of $509 million of revenue it had improperly recorded.

C. On July 6, 2010, a final judgment was entered against Cappel, permanently enjoining her from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5 and 13b2-1 thereunder, and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder, in the civil action entitled Securities and Exchange Commission v. Ilse Cappel, Civil Action No. 02 CV 2310 (S.D. Cal.).

D. The Commission's First Amended Complaint ("complaint") alleged, among other things, that Peregrine's management engaged in deceptive sales and accounting practices, and that Peregrine filed with the Commission materially false financial statements for at least eleven quarters, covering fiscal years 2000, 2001, and the first three quarters of fiscal 2002. In one portion of the fraud, Cappel and others engaged in a scheme to conceal Peregrine's difficulties in collecting its accounts receivable. Those difficulties arose because Peregrine improperly recorded revenue on non-binding arrangements it entered into with customers. Cappel and the others concealed the accounts receivable problems by, among other things, selling fictitious receivables to banks and improperly accounting for cash collected at quarter end. In addition, the complaint alleged, Cappel sold Peregrine stock while in possession of material nonpublic information about the fraud. According to the complaint, by engaging in this and other conduct

Cappel violated the antifraud provisions of the federal securities laws and the books and records, reporting, and internal accounting control provisions of the Exchange Act.

IV.

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

Accordingly, IT IS HEREBY ORDERED, effective immediately, that Cappel is suspended from appearing or practicing before the Commission as an accountant.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9127 / July 8, 2010

SECURITIES EXCHANGE ACT OF 1934
Release No. 62474 / July 8, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3051 / July 8, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3151 / July 8, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13962

In the Matter of

Ephraim Fields

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, AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that

Respondent

1. Fields, age 43, resides in New York, New York. During the relevant period, he was the owner and manager of a registered investment adviser, Clarus Capital Management, LLC ("Clarus Management"). Fields was also the general partner of Clarus Capital, LLC ("Clarus"), an unregistered hedge fund.

Other Relevant Entities

2. Clarus Management, during the relevant period, was a registered investment adviser based in New York, New York. It served as an adviser to Clarus. On December 23, 2008, Clarus Management submitted its Form ADV-W Notice of Withdrawal From Registration as an Investment Adviser, which was approved, and it ceased conducting advisory business.

3. Hawk Corporation ("Hawk"), a Delaware corporation headquartered in Cleveland, Ohio, is a supplier of products used in industrial, agricultural, performance, and aerospace applications. Its common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and is traded on the American Stock Exchange under the symbol HWK.

Background

4. This case involves marking the closing price of Hawk's stock to delay the requirement that it comply with the internal control provisions promulgated under Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404") in Rule 13a-15 under the Exchange Act.

5. SOX 404 requires management and auditors of public companies to annually assess and report on the design and effectiveness of the company's internal control over financial reporting. After the enactment of SOX 404, the Commission issued a number of extensions for non-accelerated filers, including those issuers with worldwide market values of

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

the voting and non-voting common equity held by their non-affiliates of less than $75 million. A September 22, 2005 extension provided that non-accelerated filers did not have to comply with the SOX 404 requirements until their first fiscal year ending on or after July 15, 2007.

6. Under the September 22, 2005 extension, Hawk could avoid compliance with SOX 404 for its fiscal year ending December 31, 2006, if Hawk's worldwide market value of the voting and non-voting common equity held by its non-affiliates was less than $75 million on the last day of the second quarter of 2006 - June 30, 2006. If Hawk stayed below the $75 million threshold, it would remain a non-accelerated filer and have until the end of 2007 to comply with SOX 404. The closing price of Hawk's stock on June 30, 2006 would be used to determine the market value of the voting and non-voting common equity held by Hawk's non-affiliate shareholders. On June 30, 2006, the closing price that would have triggered Hawk's obligation to comply with SOX 404 for its fiscal year ended December 31, 2006 was $12.30 (the "trigger price").

7. On June 30, 2006, one of Hawk's Corporate Executives called Fields. In that call, the Corporate Executive stated that if Hawk's stock closed below the trigger price that day, Hawk could avoid compliance with SOX 404 by year-end. Based on the call, Fields believed the Corporate Executive wanted him to make sure that Hawk's stock closed below the trigger price.

8. Shortly after the call with the Corporate Executive, Fields submitted eight limit day orders on behalf of Clarus to sell a total of 40,000 shares of Hawk at $12.29. This trading position was unusually large in light of the fact that the average daily trading volume for Hawk in the second quarter was 11,371 shares a day. Fields placed these orders to artificially cap the closing price of Hawk shares below the $12.30 per share trigger price in order to allow Hawk to avoid compliance with SOX 404.

9. Only 400 of the 40,000 shares sold before the end of the day on June 30, 2006. The sale of these 400 shares was reported as the last trade of that day. The outstanding offer to sell the remaining 39,600 shares at $12.29 was the prevailing offer to sell at the close of trading. As a result, Hawk's stock price was capped that day at $12.29. At the end of the day on June 30, 2006, the remainder of these limit day orders expired.

10. As a result of the conduct described above, Fields willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(f) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Fields cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent Fields is censured.

C. Respondent Fields shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $50,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Ephraim Fields as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Timothy L. Warren, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Chicago, IL 60604.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 13, 2010

In the Matter of **Fineline Holdings, 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 Fineline Holdings, Inc. because it has not filed any periodic reports since the period ended September 30, 2004.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed 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 July 13, 2010, through 11:59 p.m. EDT on July 26, 2010.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E Harmon
Deputy Secretary

11 of 47

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62484 / July 13, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13963

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

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Fineline Holdings, Inc. ("FNLH") (CIK No. 1037321)[1] is a void Delaware corporation located in Kent, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FNLH 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, 2004, which reported a net loss of $22,629 for the prior three months. As of July 12, 2010, the common stock of FNLH 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).

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

[1] The short form of the Respondent's name is also its ticker symbol.

reports, and failed to heed a delinquency letters 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, 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 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 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

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62486 / July 13, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3152 / July 13, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13964

In the Matter of MATTHEW C. GLESS, Respondent.	ORDER OF FORTHWITH SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Matthew C. Gless ("Gless") pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. § 200.102(e)(2)].[1]

II.

The Commission finds that:

1. Gless, age 44, is a resident of Long Beach, California. Gless was employed at Peregrine Systems, Inc. ("Peregrine") from 1996 until 2002. From 1996 until 1999, he was Peregrine's Controller. In 1999 he was promoted to Chief Accounting Officer and, in 2000, he was promoted to Chief Financial Officer and joined the Board of Directors.

[1] Rule 102(e)(2) provides in pertinent part: "Any ... person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission."

2. On April 3, 2009, an amended judgment of conviction was entered against Gless in *United States v. Matthew C. Gless,* No. 03CR1090-W, in the United States District Court for the Southern District of California, finding him guilty of one count of conspiracy and one count of securities fraud in connection with a fraud that took place at Peregrine.

3. As a result of this conviction, Gless was sentenced to 63 months imprisonment in a federal penitentiary and ordered to pay restitution in the amount of $2,088, 812.

III.

In view of the foregoing, the Commission finds that Gless has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED, that Gless is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E Harmon
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 14, 2010

In the Matter of E-Sync Networks, Inc. (n/k/a ESNI, Inc.), EchoCath, Inc., Edison Brothers Stores, Inc., Electronic Technology Group, Inc. (n/k/a SolutionNet International, Inc.), EMCEE Broadcast Products, Inc., ERD Waste Corp., Eurasia Gold Fields, Inc., European Micro Holdings, Inc., and Exotech, 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 E-Sync Networks, Inc. (n/k/a ESNI, Inc.) because it has not filed any periodic reports since the period ended December 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of EchoCath, Inc. because it has not filed any periodic reports since the period ended May 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Edison Brothers Stores, Inc. because it has not filed any periodic reports since October 31, 1998.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Electronic Technology Group, Inc. (n/k/a SolutionNet International, Inc.) because it has not filed any periodic reports since the period ended April 30, 1994.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of EMCEE Broadcast Products, Inc. because it has not filed any periodic reports since the period ended September 30, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of ERD Waste Corp. because it has not filed any periodic reports since the period ended June 30, 1997.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Eurasia Gold Fields, Inc. because it has not filed any periodic reports since the period ended September 30, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of European Micro Holdings, Inc. because it has not filed any periodic reports since the period ended June 30, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Exotech, Inc. because it has not filed any periodic reports since the period ended March 31, 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 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 July 14, 2010, through 11:59 p.m. EDT on July 27, 2010.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62498 / July 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-12432

In the Matter of

BISYS Fund Services, Inc.,

Respondent.

ORDER DIRECTING DISBURSEMENT OF FAIR FUND

On May 29, 2009, the Commission published a "Notice of Proposed Plan of Distribution and Opportunity for Comment" ("Notice") in connection with this proceeding pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1103 (Exchange Act Release No. 60011). The Notice advised parties that they could obtain a copy of the Proposed Plan of Distribution ("Distribution Plan") at www.sec.gov. The Notice also advised that all persons desiring to comment on the Distribution Plan could submit their comments, in writing, no later than June 29, 2009. No comments were received by the Commission in response to the Notice. On September 25, 2009, the Commission issued an Order Approving Distribution Plan, Appointing a Fund Administrator, and Waiving Bond (Exchange Act Rel. No. 60719).

The Distribution Plan provides that the Fair Fund consisting of disgorgement, prejudgment interest, and civil penalties, plus any accrued interest less a reserve for expenses and taxes, be transferred by the Commission to U.S. Bank for distribution by the Fund Administrator when a validated list of payees with the identification information required to make the distribution has been received and accepted by the staff. The validated list of payees, which is in the amount of $22,422,911.40, has been received and accepted.

Accordingly, it is ORDERED that the Commission staff shall transfer $22,422,911.40 of the Fair Fund to U.S. Bank, and the Fund Administrator shall distribute such monies to investors, as provided for in the Distribution Plan.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62494 / July 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13966

In the Matter of **E-Sync Networks, Inc.** **(n/k/a ESNI, Inc.),** **EchoCath, Inc.,** **Edison Brothers Stores, Inc.,** **Electronic Technology Group, Inc.** **(n/k/a SolutionNet International, Inc.),** **EMCEE Broadcast Products, Inc.,** **ERD Waste Corp.,** **Eurasia Gold Fields, Inc.,** **European Micro Holdings, Inc., and** **Exotech, 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 E-Sync Networks, Inc. (n/k/a ESNI, Inc.), EchoCath, Inc., Edison Brothers Stores, Inc., Electronic Technology Group, Inc. (n/k/a SolutionNet International, Inc.), EMCEE Broadcast Products, Inc., ERD Waste Corp., Eurasia Gold Fields, Inc., European Micro Holdings, Inc., and Exotech, Inc.

16 of 47

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. E-Sync Networks, Inc. (n/k/a ESNI, Inc.) (CIK No. 107559) is a void Delaware corporation located in Milford, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). E-Sync Networks 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, 2001, which reported a net loss of $4,936,000 for the prior year. As of July 9, 2010, the company's stock (symbol "ESNI") 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. EchoCath, Inc. (CIK No.. 1000926) is a New Jersey corporation located in Princeton, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). EchoCath 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 May 31, 2001, which reported a net loss of $1,775,242 for the prior nine months. As of July 9, 2010, the company's stock (symbol "ECHTA") 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. Edison Brothers Stores, Inc. (CIK No. 31575) is a void Delaware corporation located in Wilmington, Delaware with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Edison Brothers Stores is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended October 31, 1998, which reported a net loss of $17,800 for the prior thirteen weeks. On March 9, 1999, the company filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Delaware, and the case was closed on September 1, 2006. As of July 9, 2010, the company's stock (symbol "EDBR") 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).

4. Electronic Technology Group, Inc. (CIK No. 854556) (n/k/a SolutionNet International, Inc.) (CIK No. 1093468) is a Minnesota corporation located in Princeton, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Electronic Technology Group 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 April 30, 1994, which reported a net loss of $59,357 for the prior three months. SolutionNet acquired Electronic Technology Group, Inc., but both issuers have their own CIK numbers, thus we request that the securities of both issuers be suspended or revoked. On April 25, 1995, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Minnesota, and the case was closed on February 8, 2001. As of July 9, 2010, the company's stock (symbol "SLNN") 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. EMCEE Broadcast Products, Inc. (CIK No. 32312) is a void Delaware corporation located in White Haven, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Emcee Broadcast Products is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2002, which reported a net loss of $400,618 for the prior six months. On February 24, 2003, the company filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Middle District of Pennsylvania, and the case was still pending as of June 24, 2010. As of July 9, 2010, the company's stock (symbol "ECIN") 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. ERD Waste Corp. (CIK No. 921512) is a void Delaware corporation located in Rahway, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ERD Waste 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, 1997, which reported a net loss of $1,659,196 for the prior nine months. On April 30, 2001, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of New Jersey, and the case was terminated on June 24, 2003. As of July 9, 2010, ERD Waste's stock (symbol "ERDIQ") 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).

7. Eurasia Gold Fields, Inc. (CIK No. 1058262) is a Florida corporation located in Vancouver, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Eurasia Gold 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, 2004, which reported a net loss of $211,715 for the prior three months. As of July 9, 2010, Eurasia Gold's stock (symbol "EUGD") was quoted on the Pink Sheets, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

8. European Micro Holdings, Inc. (CIK No. 1052914) is a Nevada corporation located in Fort Lauderdale, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). European Micro 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 June 30, 2007, which reported a net loss of $51 for the prior twelve months. As of July 9, 2010, European Micro's stock (symbol "EMCC") 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).

9. Exotech, Inc. (CIK No. 34047) is a void Delaware corporation located in Gaithersburg, Maryland with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Exotech 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, 2002, which reported a net loss of $106,543 for the prior twelve months. As of July 9, 2010, Exotech's stock (symbol "EXTC") 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).

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

A. Whether the allegations contained in Section II 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

Elizabeth M. Murphy
Secretary

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62498 / July 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-12432

In the Matter of **BISYS Fund Services, Inc.,** **Respondent.**	**ORDER DIRECTING DISBURSEMENT OF FAIR FUND**

On May 29, 2009, the Commission published a "Notice of Proposed Plan of Distribution and Opportunity for Comment" ("Notice") in connection with this proceeding pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1103 (Exchange Act Release No. 60011). The Notice advised parties that they could obtain a copy of the Proposed Plan of Distribution ("Distribution Plan") at www.sec.gov. The Notice also advised that all persons desiring to comment on the Distribution Plan could submit their comments, in writing, no later than June 29, 2009. No comments were received by the Commission in response to the Notice. On September 25, 2009, the Commission issued an Order Approving Distribution Plan, Appointing a Fund Administrator, and Waiving Bond (Exchange Act Rel. No. 60719).

The Distribution Plan provides that the Fair Fund consisting of disgorgement, prejudgment interest, and civil penalties, plus any accrued interest less a reserve for expenses and taxes, be transferred by the Commission to U.S. Bank for distribution by the Fund Administrator when a validated list of payees with the identification information required to make the distribution has been received and accepted by the staff. The validated list of payees, which is in the amount of $22,422,911.40, has been received and accepted.

Accordingly, it is ORDERED that the Commission staff shall transfer $22,422,911.40 of the Fair Fund to U.S. Bank, and the Fund Administrator shall distribute such monies to investors, as provided for in the Distribution Plan.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240, 270, 274, and 275

[Release Nos. 34-62495; IA-3052; IC-29340; File No. S7-14-10]

RIN 3235-AK43

CONCEPT RELEASE ON THE U.S. PROXY SYSTEM

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comments.

SUMMARY: The Commission is publishing this concept release to solicit comment on various aspects of the U.S. proxy system. It has been many years since we conducted a broad review of the system, and we are aware of industry and investor interest in the Commission's consideration of an update to its rules to promote greater efficiency and transparency in the system and enhance the accuracy and integrity of the shareholder vote. Therefore, we seek comment on the proxy system in general, including the various issues raised in this release involving the U.S. proxy system and certain related matters.

DATES: Comments should be received on or before 90 days after publication in the Federal Register.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/concept.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-14-10 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.

All submissions should refer to File Number S7-14-10. 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/concept.shtml). Comments are also available for Web site viewing and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. 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: Raymond A. Be or Lawrence A. Hamermesh, Division of Corporation Finance, at (202) 551-3500, Susan M. Petersen or Andrew Madar, Division of Trading & Markets, at (202) 551-5777, Holly L. Hunter-Ceci or Brian P. Murphy, Division of Investment Management, at (202) 551-6825, or Joshua White, Division of Risk, Strategy, and Financial Innovation, at (202) 551-6655, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

* * * * *

I. Introduction

Regulation of the proxy solicitation process is one of the original responsibilities that Congress assigned to the Commission in 1934. The Commission has actively monitored the proxy process since receiving this authority and has considered changes when it appeared that the process was not functioning in a manner that adequately protected the interests of investors.[1] In recent years, a number of our proxy-related rulemakings have been spurred by the Internet and other technological advances that enable more efficient communications. For example, we have adopted the "notice and access" model for the delivery of proxy materials,[2] as well as rules to facilitate the use of electronic shareholder forums.[3] Perceived deficiencies in the proxy distribution process have prompted other proxy-related rulemakings, such as rules to reinforce the obligation

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1 For a history of the Commission's efforts to regulate the proxy process since 1934, see Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 Vand. L. Rev. 1129 (Oct. 1993).

2 17 CFR 240.14a-16; Shareholder Choice Regarding Proxy Materials, Release No. 34-56135 (July 26, 2007) [72 FR 42222] ("Notice and Access Release"); Amendments to Rules Requiring Internet Availability of Proxy Materials, Release No. 33-9108 (Feb. 22, 2010) [75 FR 9074].

3 17 CFR 240.14a-17; Electronic Shareholder Forums, Release No. 34-57172 (Jan. 18, 2008) [73 FR 4450]. These amendments clarified that participation in an electronic shareholder forum that could potentially constitute a solicitation subject to the proxy rules is exempt from most of the proxy rules if all of the conditions to the exemption are satisfied. In addition, the amendments state that a shareholder, issuer, or third party acting on behalf of a shareholder or issuer that establishes, maintains or operates an electronic shareholder forum will not be liable under the federal securities laws for any statement or information provided by another person participating in the forum. The amendments did not provide an exemption from Rule 14a-9 [17 CFR 240.14a-9], which prohibits fraud in connection with the solicitation of proxies.

of issuers to distribute proxy materials to banks and brokers on a timely basis[4] and to permit the "householding" of proxy materials.[5] We have also periodically revised our rules requiring certain types of disclosures in the proxy statement, such as information on executive compensation and corporate governance matters.[6] We also have pending a proposal to adopt rules that would require, under certain circumstances, a company to include in its proxy materials a shareholder's, or group of shareholders', nominees for director.[7]

During many of these previous proxy-related rulemakings, commentators raised concerns about the proxy system as a whole.[8] In addition, the Commission's staff often receives complaints from individual investors about the administration of the proxy system.[9] We believe that these concerns and complaints merit attention because they address a subject of considerable importance—the corporate proxy--which, given the wide dispersion of shareholders, is the principal means by which shareholders can exercise their voting rights.

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4 See 17 CFR 14b-1 and 14b-2; Timely Distribution of Proxy and Other Soliciting Material, Release No. 34-33768 (Mar. 16, 1994) [59 FR 13517].

5 Delivery of Proxy Statements and Information Statements to Households, Release No. 33-7912 (Oct. 27, 2000) [65 FR 65736]. "Householding" permits a securities intermediary to send only one copy of proxy materials to multiple accounts within the same household under specified conditions. Id.

6 See, e.g., Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334] and Executive Compensation and Related Person Disclosure, Release No. 33-8732A (Aug. 9, 2006) [71 FR 53158].

7 See Facilitating Shareholder Director Nominations, Release Nos. 33-9046, 34-60089, IC-287665 (June 10, 2009) [74 FR 29024].

8 See, e.g., Request for Rulemaking Concerning Shareholder Communications, April 12, 2004–Business Roundtable Petition 4-493 ("BRT Petition"); comment letter to Release No. 33-9046, note 7, above, from Altman Group; comment letters to Security Holder Director Nominations, Release No. 34-48626 (Oct. 14, 2003) [68 FR 60784] from Intel and Georgeson Shareholder Communications.

9 Most commonly submitted to the Commission's Office of Investor Education and Advocacy, these complaints raise issues such as, for example, technical problems with electronic voting platforms offered by proxy service providers and failures by issuers to respond to shareholder complaints about proxy-related matters.

Accordingly, in this release, we are reviewing and seeking public comment as to whether the U.S. proxy system as a whole operates with the accuracy, reliability, transparency, accountability, and integrity that shareholders and issuers should rightfully expect. With over 600 billion shares voted every year at more than 13,000 shareholder meetings,[10] shareholders should be served by a well-functioning proxy system that promotes efficient and accurate voting. Moreover, recent developments, such as the revisions to Rule 452 of the New York Stock Exchange ("NYSE") limiting the ability of brokers to vote uninstructed shares in uncontested director elections[11] and other corporate governance trends such as increased adoption of a majority voting standard for the election of directors[12] have highlighted the importance of accuracy and accountability in the voting process.

The manner in which proxy materials are distributed and votes are processed and recorded involves a level of complexity not generally understood by those not involved in

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10 See Broadridge 2009 Key Statistics and Performance Ratings, available at http://www.broadridge.com/investor-communications/us/2009ProxyStats.pdf.

11 Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered under the Investment Company Act of 1940, and to Codify Two Previously Published Interpretations that Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts with an Investment Company, Release No. 34-60215 (July 1, 2009) [74 FR 33293] (Commission approval of amendments to NYSE Rule 452).

12 Historically, many corporate directors were elected under a plurality standard, which required only that a candidate receive more votes than other candidates, but not a majority of the votes. Since there ordinarily are not more candidates than seats, the election threshold has historically been low and shareholder participation was less important to electing directors. See American Bar Association Section of Business Law, Report of the Committee on Corporate Laws on Voting by Shareholders for the Election of Directors (Mar. 13, 2006), available at http://www.abanet.org/buslaw/committees/CL270000pub/directorvoting/20060313000001.pdf. From 2005 to 2007, however, a majority of companies in the S&P 500 index adopted a voting policy, through bylaw amendments or changes in corporate governance principles, that requires directors who do not receive a majority of votes cast at the meeting in favor of their election to tender their resignation to the board, which resignation the board may or may not accept. See Claudia H. Allen, Study of Majority Voting in Director Elections (Nov. 12, 2007), available at http://www.ngelaw.com/files/upload/majoritystudy111207.pdf.

the process. This complexity stems, in large part, from the nature of share ownership in the United States, in which the vast majority of shares are held through securities intermediaries such as broker-dealers or banks; this structure supports prompt and accurate clearance and settlement of securities transactions, yet adds significant complexity to the proxy voting process.[13] As a result, the proxy system involves a wide array of third-party participants in addition to companies and their shareholders, including brokers, banks, custodians, securities depositories, transfer agents, proxy solicitors, proxy service providers, proxy advisory firms, and vote tabulators.[14] The use of some of these third parties improves efficiencies in processing and distributing proxy materials to shareholders, while at the same time the increased reliance on these third parties—some of which are not directly regulated by federal or state securities regulators—adds complexity to the proxy system and makes it less transparent to shareholders and to issuers. Studies of the proxy systems in other jurisdictions, including the United Kingdom and the European Union, have made similar observations.[15]

13 See Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner of such Securities Pursuant to Section 12(m) of the Securities Exchange Act of 1934, Dec. 3, 1976 (the "Street Name Study").

14 The focus of this release is the U.S. proxy system. We recognize, however, that many U.S. persons hold shares in non-U.S. issuers. While this release does not address the processes and procedures followed by participants when non-U.S. issuers distribute proxy-related materials to U.S. persons, we are interested in information about those processes and procedures. We also seek comment about whether we should consider regulatory responses to issues that may arise in that area.

15 A report from the United Kingdom has characterized its voting process as one in which the chain of accountability is complex, where there is a lack of transparency and where there are a large number of different participants, each of whom may give a different priority to voting. See Review of the impediments to voting UK shares: Report by Paul Myners to the Shareholder Voting Working Group (Jan. 2004) ("Myners Report"). The European Union also has considered issues related to proxy voting and has enacted rules and legislation in response. As a result, the European Union passed a directive on the exercise of certain rights of shareholders in listed companies in July 2007, which covers many of the matters discussed in this release. See Directive 2007/36/EC of the European Parliament and of the Council (July 11, 2007) ("Shareholder Rights Directive"). The Shareholder Rights Directive addresses the issues of record dates, transparency,

We begin this concept release with an overview of the U.S. proxy system. We then outline some of the concerns that have been raised regarding the accuracy, reliability, transparency, accountability, and integrity of this system, as well as possible regulatory responses to these concerns. These concerns generally relate to three principal questions:

- Whether we should take steps to enhance the accuracy, transparency, and efficiency of the voting process;
- Whether our rules should be revised to improve shareholder communications and encourage greater shareholder participation; and
- Whether voting power is aligned with economic interest and whether our disclosure requirements provide investors with sufficient information about this issue.

In reviewing the performance of the proxy system, the Commission's staff has recently had numerous discussions with a variety of participants in the proxy voting process, and we appreciate the insights these participants have provided.[16] While we set

electronic communications, conflicts of interest, financial intermediaries and other parties involved in the proxy voting process.

16 Beginning in September of 2009, the Commission's staff has met with representatives of the following groups and individuals to discuss issues about the U.S. proxy system: The Altman Group; Broadridge Financial Solutions, Inc.; Broadridge Steering Committee; Council of Institutional Investors ("CII"); Edwards, Angell, Palmer & Dodge; Glass, Lewis & Co.; the Hong Kong Securities & Futures Commission; International Corporate Governance Network ("ICGN"); InvestShare; McKenzie Partners; Mediant Communications; Moxy Vote; National Investor Relations Institute ("NIRI"); Proxy Governance, Inc.; RiskMetrics Group; Professor Edward Rock; Shareholder Communications Coalition; Securities Industry and Financial Markets Association ("SIFMA"); Society of Corporate Secretaries and Governance Professionals; Sodali; Target Corp.; TIAA-CREF; the U.K. Financial Reporting Council; and Weil, Gotshal & Manges, LLP. The staff has also been in communication with other regulators, including the Federal Reserve, FDIC, Office of the Comptroller of Currency, and Office of Thrift Supervision. Several of the above-listed parties provided written materials to the staff, which we are including in the public comment file for this release. The SEC Investor Advisory Committee has also recommended an inquiry into data-tagging proxy information, as described in Section IV.C below.

forth a number of general and specific questions, we welcome comments on any other concerns related to the proxy process that commentators may have, and we specifically invite comment on any costs, burdens or benefits that may result from possible regulatory responses identified in this release. We recognize that the various aspects of the proxy system that we address in this release are interconnected, and that changes to one aspect may affect other aspects, as well as complement or frustrate other potential changes.[17] We encourage the public to consider these relationships when formulating comments. Interested persons are also invited to comment on whether alternative approaches, or a combination of approaches, would better address the concerns raised by the current process.

We are mindful that, while we have recently amended—and are considering amending—a number of our rules that relate to the proxy process, further amendments to those rules or additional guidance about our views on their application may be appropriate to address concerns raised by the application of those rules. Although the discussion in this release generally focuses on the broader proxy system, we remain interested in ways to improve our proxy disclosure, solicitation, and distribution rules. We seek public comment on the concerns about those rules.

II. The Current Proxy Distribution and Voting Process

A fundamental tenet of state corporation law is that shareholders have the right to vote their shares to elect directors and to approve or reject major corporate transactions at

[17] For example, the feasibility of establishing a means of vote confirmation may depend on whether and to what extent we continue to allow beneficial owners to object to the disclosure of their identities to issuers. See Sections III.B and IV.A, below.

shareholder meetings.[18] Under state law, shareholders can appoint a proxy to vote their shares on their behalf at shareholder meetings,[19] and the major national securities exchanges generally require their listed companies to solicit proxies for all meetings of shareholders.[20] Because most shareholders do not attend public company shareholder meetings in person, voting occurs almost entirely by the use of proxies that are solicited before the shareholder meeting,[21] thereby resulting in the corporate proxy becoming "the forum for shareholder suffrage."[22] Issuers with a class of securities registered under Section 12 of the Securities Exchange Act of 1934 ("Exchange Act") and issuers that are registered under the Investment Company Act of 1940 ("Investment Company Act") are required to comply with the federal proxy rules in Regulation 14A when soliciting proxies from shareholders.[23]

A. Types of Share Ownership and Voting Rights

The proxy solicitation process starts with the determination of who has the right to receive proxy materials and vote on matters presented to shareholders for a vote at shareholder meetings. The method for making this determination depends on the way the

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18 See, e.g., Del. Code Ann. tit. 8, §§ 211 and 212; Model Bus. Corp. Act §§7.01 and 7.21. While voting in the election of directors is largely the exclusive right of stockholders, state law may permit the corporation to grant voting rights to holders of other securities, such as debt. See, e.g., Del. Code Ann. tit. 8, § 221. For a brief review of the rationale for voting by shareholders, see Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law (1991). We refer to Delaware law frequently because of the large percentage of public companies incorporated under that law. The Delaware Division of Corporations reports that over 50% of U.S. public companies are incorporated in Delaware. We refer to the Model Business Corporation Act as well because the corporate statutes of many states adopt or closely track its provisions.

19 See, e.g., Del Code Ann. tit. 8, § 212(b); Model Bus. Corp. Act §7.22(b).

20 See, e.g., NYSE Listed Company Manual § 402.04(a); Nasdaq Listing Rule 5620(b).

21 Although voting rights in public companies are exercised only at the meeting of shareholders, the votes cast at the meeting are almost entirely by proxy and the voting decisions have been made during the proxy solicitation process.

22 Roosevelt v. E.I duPont de Nemours & Co., 958 F.2d 416, 422 (D.C. Cir. 1992).

23 17 CFR 240.14a-1 et seq.; 17 CFR 270.20a-1. However, securities of foreign private issuers are exempt from the proxy rules. See 17 CFR 240.3a12-3.

shares are owned. There are two types of security holders in the U.S.—registered owners and beneficial owners.

1. Registered Owners

Registered owners (also known as "record holders") have a direct relationship with the issuer because their ownership of shares is listed on records maintained by the issuer or its transfer agent.[24] State corporation law generally vests the right to vote and the other rights of share ownership in registered owners.[25] Because registered owners have the right to vote, they also have the authority to appoint a proxy to act on their behalf at shareholder meetings.[26]

Registered owners can hold their securities either in certificated form[27] or in electronic (or "book-entry") form through a direct registration system ("DRS"),[28] which

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24 The Uniform Commercial Code ("UCC") defines the term "registered form," as applied to a certificated security, as a form in which the security certificate specifies a person entitled to the security, and a transfer of the security may be registered on books maintained for that purpose by or on behalf of the issuer, or the security certificate so states. UCC 8-102(a)(13) (1994). Rule 14a-1 under the Exchange Act [17 CFR 240.14a-1] defines the term "record holder" for purposes of Rules 14a-13, 14b-1 and 14b-2 [17 CFR 240.14a-13, 14b-1, 14b-2] to mean any broker, dealer, voting trustee, bank, association or other entity that exercises fiduciary powers which holds securities on behalf of beneficial owners and deposits such securities for safekeeping with another bank. Additionally, the Commission's transfer agent rules refer to registered owners as security holders, which means owners of securities registered on the master security holder file of the issuer. Rule 17Ad-9 under the Exchange Act [17 CFR 240.17Ad-9] defines master security holder file as the official list of individual security holder accounts.

25 See, e.g., Del. Code Ann. tit. 8, § 219(c); Model Bus. Corp. Act §1.40(21); but see Model Bus. Corp. Act §7.23 (permitting corporations to establish procedures by which beneficial owners become entitled to exercise rights, including voting rights, otherwise exercisable by shareholders of record).

26 See, e.g., Del. Code Ann. tit. 8, § 212(b); Model Bus. Corp. Act §7.22(b).

27 A securities certificate evidences that the owner is registered on the books of the issuer as a shareholder. State commercial laws specify rules concerning the transfer of the rights that constitute securities and the establishment of those rights against the issuer and other parties. See Official comment to Article 8-101, The American Law Institute and National Conference of Commissioners of Uniform State Laws, Uniform Commercial Code, 1990 Official Text with Comments (West 1991).

28 For more information about DRS generally, see Securities Transactions Settlement, Release No. 33-8398 (Mar. 11, 2004) [69 FR 12922]. For a detailed description of DRS and the DRS facilities administered by DTC, see Order Granting Accelerated Approval of a Proposed Rule Change

enables an investor to have his or her ownership of securities recorded on the books of the issuer without having a physical securities certificate issued.[29] Under DRS, an investor can electronically transfer his or her securities to a broker-dealer to effect a transaction without the risk, expense, or delay associated with the use of securities certificates. Investors holding their securities in DRS retain the rights of registered owners, without having the responsibility of holding and safeguarding securities certificates.

2. Beneficial Owners

The vast majority of investors in shares issued by U.S. companies today are beneficial owners, which means that they hold their securities in book-entry form through a securities intermediary, such as a broker-dealer or bank.[30] This is often referred to as owning in "street name." A beneficial owner does not own the securities directly.

Relating to the Procedures to Establish a Direct Registration System, Release No. 34-37931 (Nov. 7, 1996) [61 FR 58600] (order granting approval to establish DRS) and Notice of Filing of Amendment and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Implementation of the Profile Modification System Feature of the Direct Registration System, Release No. 34-41862 (Sept. 10, 1999) [64 FR 51162] (order approving implementation of the Profile Modification System).

29 DRS is an industry initiative aimed at dematerializing equities in the U.S. market. Dematerialization of securities occurs where there are no paper certificates available, and all transfers of ownership are made through book-entry movements. Immobilization of securities occurs where the underlying certificate is kept in a securities depository (or held in custody for the depository by the issuer's transfer agent) and transfers of ownership are recorded through electronic book-entry movements between the depository's participants' accounts. Securities are partially immobilized (as is the case with most U.S. equity securities traded on an exchange or securities association) when the street name positions are immobilized at the securities depository but certificates are still available to investors directly registered on the issuer's books. Although most options, municipal, government and many debt securities trading in the U.S. markets are currently dematerialized, many equity and some debt securities remain immobilized or partially immobilized at the Depository Trust Company ("DTC"). For more information about DTC, see Section II.B.2.a, below. Most if not all equity securities not on deposit at DTC but trading publicly in the U.S. markets remain fully certificated.

30 For purposes of Commission rules pertaining to the transfer of certain securities, a "securities intermediary" is defined under Exchange Act Rule 17Ad-20 [17 CFR 240.17Ad-20] as a clearing agency registered under Exchange Act Section 17A [15 USC 78q-1] or a person, including a bank, broker, or dealer, that in the ordinary course of its business maintains securities accounts for others in its capacity as such. The UCC defines the term slightly differently, but for purposes of this release, this distinction is irrelevant. See UCC 8-102(a)(14) (1994).

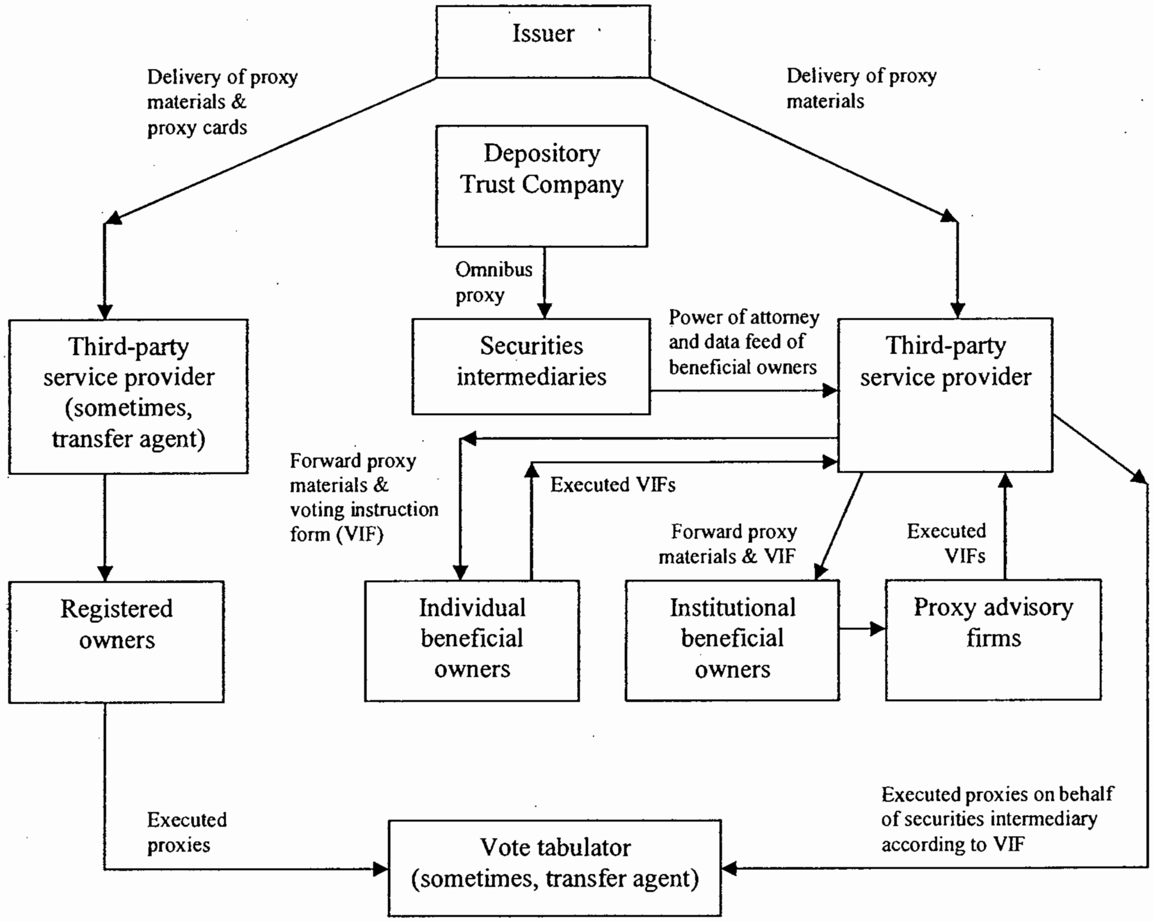
Instead, as a customer of the securities intermediary, the beneficial owner has an entitlement to the rights associated with ownership of the securities.[31]

B. The Process of Soliciting Proxies

The following diagram illustrates the flow of proxy materials that typically occurs during a solicitation. The steps illustrated in the diagram and descriptions of the relevant parties are discussed below.

31 The rights and interests that a customer has against a securities intermediary's property are created by the agreements between the customer and the securities intermediary, as well as by the UCC, as adopted in the relevant jurisdiction. Under the UCC, beneficial owners have a "securities entitlement" to the fungible bulk of securities held by the broker-dealer or bank. An "entitlement holder" is defined as a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary. UCC 8-503 (1994). A securities intermediary is obligated to provide the entitlement holder with all of the economic and governance rights that comprise the financial asset and that the entitlement holder can look only to that intermediary for performance of the obligations. See generally UCC 8-501 et seq. (1994).

Diagram 1: The Flow of Proxy Materials



1. Distributing Proxy Materials to Registered Owners

It is a relatively simple process for an issuer to send proxy materials to registered owners because their names and addresses are listed in the issuer's records, which are usually maintained by a transfer agent. As the left side of Diagram 1 illustrates, proxy materials are sent directly from the issuer through its transfer agent or third-party proxy service provider to all registered owners in paper or electronic form.[32] Registered owners

[32] Commission rules provide, generally, that proxy materials can be provided electronically to shareholders who have affirmatively consented to electronic delivery. See Use of Electronic Media for Delivery Purposes, Release No. 33-7233 (Oct. 6, 1995) [60 FR 53458]. In addition, the Commission has adopted the notice and access model that permits issuers to send shareholders a Notice of Internet Availability of Proxy Materials in lieu of the traditional paper packages

execute the proxy card and return it to the issuer's transfer agent or vote tabulator for tabulation.

2. Distributing Proxy Materials to Beneficial Owners

As the right side of Diagram 1 illustrates, the process of distributing proxy materials to beneficial owners is more complicated than it is for registered owners. The indirect system of ownership in the U.S. permits securities intermediaries to hold securities for their customers, and there can be multiple layers of securities intermediaries leading to one beneficial owner. This potential for multiple tiers of securities intermediaries presents a number of challenges in the distribution of proxy materials.

a. The Depository Trust Company

In most cases, the chain of ownership for beneficially owned securities of U.S. companies begins with the Depository Trust Company ("DTC"), a registered clearing agency acting as a securities depository.[33] Most large U.S. broker-dealers and banks are DTC participants, meaning that they deposit securities with, and hold those securities through, DTC.[34] DTC's nominee, Cede & Co., appears in an issuer's stock records as the sole registered owner of securities deposited at DTC. DTC holds the deposited securities

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including the proxy statement, annual report and proxy card. See Notice and Access Release, note 2, above. These two concepts work in tandem. Although an issuer electing to send a Notice in lieu of a full package generally would be required to send a paper copy of that Notice, it may send that Notice electronically to a shareholder who has provided an affirmative consent to electronic delivery.

33 DTC provides custody and book-entry transfer services of securities transactions in the U.S. market involving equities, corporate and municipal debt, money market instruments, American depositary receipts, and exchange-traded funds. In accordance with its rules, DTC accepts deposits of securities from its participants (i.e., broker-dealers and banks), credits those securities to the depositing participants' accounts, and effects book-entry movements of those securities. For more information about DTC, see http://www.dtcc.com/about/subs/dtc.php.

34 Participants in DTC are usually broker-dealers or banks. Currently, there are approximately 400 DTC participants. See http://www.dtcc.com/customer/directories/dtc/dtc.php. Other jurisdictions have entities similar to the DTC. For example, Canada has the Clearing and Depository Services Inc., which is its national securities depository and clearing and settlement entity.

in "fungible bulk," meaning that there are no specifically identifiable shares directly owned by DTC participants.[35] Rather, each participant owns a pro rata interest in the aggregate number of shares of a particular issuer held at DTC. Correspondingly, each customer of a DTC participant–such as an individual investor–owns a pro rata interest in the shares in which the DTC participant has an interest.

Once an issuer establishes a date for the shareholder meeting and a record date for shareholders entitled to vote on matters presented at the meeting, it sends a formal announcement of these dates to DTC, which DTC forwards to all of its participants.[36] The issuer then requests from DTC a "securities position listing"[37] as of the record date, which identifies the participants having a position in the issuer's securities and the number of securities held by each participant.[38] DTC must promptly respond by providing the issuer with a list of the number of shares in each DTC participant's account as of the record date.[39] The record date securities position listing establishes the number of shares that a participant is entitled to vote through its DTC proxy.[40]

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35 See UCC 8-503(b) (1994) (a beneficial owner's property interest with respect to shares "is a pro rata property interest in all interests in that financial asset held by the securities intermediary").

36 NYSE-listed issuers are also required to provide the NYSE with notification of the record and meeting dates. See NYSE Listed Company Manual § 401.02.

37 Exchange Act Rule 17Ad-8 defines a "securities position listing" as a list of those participants in the clearing agency on whose behalf the clearing agency holds the issuer's securities and of the participant's respective positions in such securities as of a specified date. 17 CFR 240.17Ad-8(a).

38 Pursuant to Exchange Act Rule 17Ad-8, DTC may charge issuers requesting securities position listings a fee designed to recover the reasonable costs of providing the list. 17 CFR 240.17Ad-8(b). An issuer or its agent, generally a transfer agent or authorized third-party service provider, can subscribe to DTC's service that allows the subscriber to obtain the securities position listing once or on a weekly, monthly, or more frequent basis.

39 Upon request, a registered clearing agency must furnish a securities position listing promptly to each issuer whose securities are held in the name of the clearing agency or its nominee. 17 CFR 140.17Ad-8(b).

40 In addition to the shares held in its DTC account, some participants may also own additional securities at other securities depositories, through custodians, or in registered form.

For each shareholder meeting, DTC executes an "omnibus proxy"[41] transferring its right to vote the shares held on deposit to its participants.[42] In this manner, broker-dealer and bank participants in DTC obtain the right to vote directly the shares that they hold through DTC.

b. Securities Intermediaries: Broker-Dealers and Banks

Once the issuer identifies the DTC participants holding positions in its securities, it is required to send a search card[43] to each of those participants, as well as other securities intermediaries that are registered owners, to determine whether they are holding shares for beneficial owners and, if so, the number of sets of proxy packages needed to be forwarded to those beneficial owners. This process may involve multiple tiers of securities intermediaries holding securities on behalf of other securities intermediaries, with search cards distributed to each securities intermediary in the chain of ownership.

Commission rules require broker-dealers to respond to the issuer within seven business days with the approximate number of customers of the broker-dealer who are

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41 Rather than issue each participant a separate proxy to vote its shares, DTC drafts a single proxy (the "omnibus proxy") granting to each of the multiple participants listed in the proxy the right to vote the number of shares attributed to it in the omnibus proxy.

42 As noted in recent litigation, the execution by DTC of an omnibus proxy is neither automatic nor legally required, but occurs as a matter of common practice. Kurz v. Holbrook, 989 A.2d 140, 170 (Del. Ch. 2010), rev'd on other grounds, Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377 Del. 2010) ("There does not appear to be any authority governing when a DTC omnibus proxy is issued, who should ask for it, or what event triggers it. The parties tell me that DTC has no written policies or procedures on the matter.").

43 The search card must request: (1) the number of beneficial owners; (2) the number of proxy soliciting materials and annual reports needed for forwarding by the intermediaries to their beneficial owner customers; and (3) the name and address of any agent appointed by the bank or broker-dealer to process a request for a list of beneficial owners. The search card must be sent out at least 20 business days prior to the record date unless impracticable, in which case it must be sent as many days before the record date as practicable. 17 CFR 240.14a-13(a).

beneficial owners of the issuer's securities.[44] The Commission's rules also require banks to follow a similar process except that banks must respond to the issuer within one business day with the names and addresses of all respondent banks[45] and must respond within seven business days with the approximate number of customers of the bank who are beneficial owners of shares.[46]

Once the search card process is complete, the issuer should know the approximate number of beneficial owners owning shares through each securities intermediary. The issuer must then provide the securities intermediary, or its third-party proxy service provider, with copies of its proxy materials (including, if applicable, a Notice of Internet Availability of Proxy Materials) for forwarding to those beneficial owners. The securities intermediary must forward these proxy materials to beneficial owners no later than five business days after receiving such materials.[47] Securities intermediaries are entitled to reasonable reimbursement for their costs in forwarding these materials.[48]

Instead of receiving and executing a proxy card (as registered owners receive and do), the beneficial owner receives a "voting instruction form" or "VIF" from the

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44 17 CFR 240.14b-1(b)(1).

45 A respondent bank is a bank that holds securities through another bank that is the record holder of those securities. See Facilitating Shareholder Communications, Release No. 34-23276 (May 29, 1986) [51 FR 20504].

46 17 CFR 240.14b-2(b)(1) and 17 CFR 240.14b-2(b)(2). Banks are required to execute omnibus proxies in favor of respondent banks. 17 CFR 240.14b-2(b)(2).

47 17 CFR 240.14b-1(b)(2) and 17 CFR 240.14b-2(b)(3). The exchanges have rules that regulate the process and procedures by which member firms must transmit proxy materials to beneficial owners, collect voting instructions from beneficial owners, and vote shares held in the member firm's name. See, e.g., NYSE Rules 450 through 460 and FINRA Rule 2251.

48 17 CFR 240.14a-13(a)(5). In addition, most of the exchanges have rules specifying the maximum rates that member firms may charge listed issuers as reasonable reimbursement. For example, the NYSE rule includes a schedule of "fair and reasonable rates of reimbursement" of member broker-dealers for their out-of-pocket expenses, including reasonable clerical expenses, incurred in connection with issuers' proxy solicitations of beneficial owners. NYSE Rule 465 Supplemental Material. The other exchanges have similar rules. See the discussion on proxy distribution fees in Section III.D below.

securities intermediary, which permits the beneficial owner to instruct the securities intermediary how to vote the beneficially owned shares. Although the VIF does not give the beneficial owner the right to attend the meeting, a beneficial owner typically can attend the meeting by requesting the appropriate documentation from the securities intermediary.

C. Proxy Voting Process

Once the proxy materials have been distributed to the registered owners and beneficial owners of the securities, the means by which shareholders vote their shares differs. As Diagram 1 illustrates, registered owners execute the proxy card and return it to the vote tabulator, either by mail, by phone, or through the Internet. Beneficial owners, on the other hand, indicate their voting instructions on the VIF and return it to the securities intermediary or its proxy service provider, either by mail, by phone, or through the Internet.[49] The securities intermediary, or its proxy service provider, tallies the voting instructions that it receives from its customers. As discussed in further detail in Section IV.A of this release, the securities intermediary, or its proxy service provider, then executes and submits to the vote tabulator a proxy card for all securities held by the securities intermediary's customers.[50]

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49 Beneficial owners' voting instructions submitted by telephone account for a very small percentage of votes received by proxy service providers; for the shares of most beneficial owners who do not vote through a proprietary service for institutional investors, voting instructions are conveyed by paper or via the Internet, in approximately the same proportion. See Broadridge 2009 Key Statistics and Performance Ratings, note 10, above.

50 As noted above, the securities intermediary receives the right to execute a proxy through the omnibus proxy executed in its favor by DTC and the other securities intermediaries in the chain of ownership through which it holds the securities. Although Rule 14b-2(b)(3) [17 CFR 240.14b-2(b)(3)] explicitly permits a bank to execute a proxy in favor of its beneficial owners, and nothing in our rules prohibits a broker-dealer from doing so, it is our understanding that these intermediaries usually solicit voting instructions from their beneficial owner and execute proxies on behalf of their beneficial owners rather than executing proxies that delegate their voting authority to those beneficial owners. Beneficial owners may, however, request a proxy and attend

In certain situations, a broker-dealer may use its discretion to vote shares if it does not receive instructions from the beneficial owner of the shares. Historically, broker-dealers were generally permitted to vote shares on uncontested matters, including uncontested director elections, without instructions from the beneficial owner.[51] The NYSE recently revised this rule to prohibit broker-dealers from voting uninstructed shares with regard to any election of directors.[52]

D. The Roles of Third Parties in the Proxy Process

Issuers, securities intermediaries, and shareholders often retain third parties to perform a number of proxy-related functions, including forwarding proxy materials, collecting voting instructions, voting shares, soliciting proxies, tabulating proxies, and analyzing proxy issues,.

1. Transfer Agents

Issuers are required to maintain a record of security holders for state law purposes[53] and often hire a transfer agent[54] to maintain that record.[55] Transfer agents, as

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the shareholder meeting. It is our understanding that both banks and broker-dealers will issue a proxy that the beneficial owner may use to attend a meeting if requested to do so.

51 See NYSE Rule 452.

52 NYSE Rule 452 and NYSE Listed Issuer Manual § 402.08(B). This prohibition does not apply to issuers registered under the Investment Company Act.

53 E.g., Del. Code Ann. tit. 8, § 219(a); Model Bus. Corp. Act §16.01(c).

54 Section 3(a)(25) of the Exchange Act defines a "transfer agent" as any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (1) countersigning such securities upon issuance, (2) monitoring the issuance of such securities with a view to preventing unauthorized issuance, (3) registering the transfer of securities, (4) exchanging or converting such securities, or (5) transferring record ownership of securities by bookkeeping entry without the physical issuance of securities certificates. For more information about the role of transfer agents, see www.stai.org.

55 Exchange Act Rules 17Ad-6, 17Ad-7, 17Ad-9, 17Ad-10, and 17Ad-11 govern how transfer agents acting for issuers of securities registered under Section 12 of the Exchange Act (or that would have to be registered but for the exemption under Section 12(g)(2)(b)(i) and (ii) of the Exchange Act) must maintain certain records of the issuer, including, but not limited to, the official record of ownership (i.e., the "masterfile") and the official record of the number of securities issued and outstanding (i.e., the "control book" or the "registrar"). These rules do not address the distribution

agents of the issuer, are obliged to confirm to a vote tabulator (if the transfer agent does not itself perform the tabulation function) matters such as the amount of shares outstanding, as well as the identity and holdings of registered owners entitled to vote. Transfer agents are required to register with the Commission, which inspects and currently regulates some of their functions.[56]

2. Proxy Service Providers

To facilitate the proxy material distribution and voting process for beneficial owners, securities intermediaries typically retain a proxy service provider to perform a number of processing functions, including forwarding the proxy materials by mail or electronically and collecting voting instructions.[57] To enable the proxy service provider to perform these functions, the securities intermediary gives the service provider an electronic data feed of a list of beneficial owners and the number of shares held by each beneficial owner on the record date. The proxy service provider, on behalf of the intermediary, then requests the appropriate number of proxy material sets from the issuer for delivery to the beneficial owners. Upon receipt of the packages, the proxy service provider, on behalf of the intermediary, mails either the proxy materials with a VIF, or a

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of issuer communications, including proxy materials, or the remittance of proxies or voting instructions. To a lesser extent, the UCC, as adopted by states, also governs certain aspects of transfer agent activity relating to rights of issuers, shareholders, securities intermediaries, and those holding through securities intermediaries, some of which relate to the right to vote. The application of the UCC in this context is beyond the scope of this release.

56 Persons acting as transfer agents for any security registered under Section 12 of the Exchange Act or which would be required to be registered except for the exemption from registration provided by subsection (g)(2)(B) or (g)(2)(G) of Section 12 must register with the Commission (or, for transfer agents that are banks, with their appropriate regulatory agency) and pursuant to Section 17A of the Exchange Act must comply with Commission rules and regulations. 15 U.S.C. 78q-1(c)(1) and (d)(1).

57 A single proxy service provider, Broadridge Financial Services, Inc. ("Broadridge"), states that it currently handles over 98% of the U.S. market for such proxy vote processing services. See http://www.broadridge.com/investor-communications/us/institutions/proxy-disclosure.asp.

Notice of Internet Availability of Proxy Materials,[58] to beneficial owners. Although we do not directly regulate such proxy service providers, our regulations governing the proxy process-related obligations of securities intermediaries apply to the way in which proxy service providers perform their services because they act as agents for, and on behalf of, those intermediaries and typically vote proxies on behalf of those intermediaries pursuant to a power of attorney.

3. Proxy Solicitors

Issuers sometimes hire third-party proxy solicitors to identify beneficial owners holding large amounts of the issuers' securities and to telephone shareholders to encourage them to vote their proxies consistent with the recommendations of management. This often occurs when there is a contested election of directors, and issuer's management and other persons are competing for proxy authority to vote securities in the election (commonly referred to as a "proxy contest"). In addition, an issuer may hire a proxy solicitor in uncontested situations when voting returns are expected to be insufficient to meet state quorum requirements or when an important matter is being considered. Issuers and other soliciting persons are required to disclose the use of such services and estimated costs for such services in their proxy statements.[59]

4. Vote Tabulators

Under many state statutes, an issuer must appoint a vote tabulator (sometimes called "inspectors of elections" or "proxy tabulators") to collect and tabulate the proxy

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58 A Notice is sent pursuant to provisions in Rule 14a-16. 17 CFR 240.14a-16.

59 Item 4 of 17 CFR 240.14a-101. If similar services are performed by employees of the issuer, however, the estimated costs of such services need to be disclosed only if the employees are specially engaged for the solicitation.

votes as well as votes submitted by shareholders in person at a meeting.[60] We understand that often the issuer's transfer agent will act as the vote tabulator because most major transfer agents have the infrastructure to communicate with registered holders, proxy service providers, and securities intermediaries, while also being able to reconcile the identity of voters that are registered owners and the number of votes to the issuer's records. However, sometimes the issuer will hire an independent third party to perform this function, often to certify important votes. The vote tabulator is ultimately responsible for determining that the correct number of votes has been submitted by each registered owner.[61] In addition, proxies submitted by securities intermediaries that are not registered owners, but have been granted direct voting rights through DTC's omnibus proxy, are reconciled with DTC's securities position listing. Although the Commission does regulate transfer agents (which often serve as vote tabulators) in their roles as transfer agents, the Commission does not currently regulate vote tabulators or the function of tabulating proxies by transfer agents.

5. Proxy Advisory Firms

Institutional investors typically own securities positions in a large number of issuers. Therefore, they are presented annually with the opportunity to vote on many matters and often must exercise fiduciary responsibility in voting.[62] Some institutional investors may retain an investment adviser to manage their investments, and may also

60 See, e.g., Del. Code Ann. tit. 8, §231; Model Bus. Corp. Act §7.29.

61 Id. As noted above, transfer agents, who already possess the list of record owners, often tabulate the vote, so they possess the necessary information to make this determination. It is our understanding that, when the vote tabulator is an entity other than the transfer agent, the issuer or its transfer agent typically will provide the vote tabulator with the list of record owners to enable the vote tabulator to make this determination.

62 See Section V.A.1, below.

delegate proxy voting authority to that adviser. To assist them in their voting decisions, investment advisers (or institutional investors if they retain voting authority) frequently hire proxy advisory firms to provide analysis and voting recommendations on matters appearing on the proxy. In some cases, proxy advisory firms are given authority to execute proxies or voting instructions on behalf of their client. Some proxy advisory firms also provide consulting services to issuers on corporate governance or executive compensation matters, such as helping to develop an executive compensation proposal to be submitted for shareholder approval. Some proxy advisory firms may also qualitatively rate or score issuers, based on judgments about the issuer's governance structure, policies, and practices. As discussed in more detail elsewhere in this release, some of the activities of a proxy advisory firm can constitute a solicitation, which is governed by our proxy rules.[63] Some, but not all, proxy advisory firms operating in our markets are currently registered with us as investment advisers.[64]

III. Accuracy, Transparency, and Efficiency of the Voting Process

Investor and issuer interests may be undermined when perceived defects in the proxy system – or uncertainties about whether there are any such defects – are believed to impair its accuracy, transparency, and cost-efficiency. Because even the perception of such defects can lead to lack of confidence in the proxy process, we seek to explore concerns that have been expressed about the accuracy, transparency, and efficiency of that process and ways in which those concerns might be addressed.

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[63] Id.

[64] Id.

A. Over-Voting and Under-Voting

On occasion, vote tabulators (including transfer agents acting in that capacity) receive votes from a securities intermediary that exceed the number of shares that the securities intermediary is entitled to vote. The extent to which such votes are accepted depends on instructions from the issuer, state law, and the vote tabulator's internal policies. For example, it is our understanding that some vote tabulators accept votes from a DTC participant on a "first-in" basis up to the aggregate amount indicated in DTC's records – that is, once the votes cast by the participant exceed the number of positions indicated on the securities position listing, the vote tabulator will refuse to accept any votes subsequently remitted. Conversely, other vote tabulators, we understand, refuse to accept any votes from a securities intermediary if the aggregate number of votes submitted exceeds the vote tabulator's records for that intermediary.

In an attempt to address issuers' concerns about the potential for over-voting, securities intermediaries and their service providers have implemented systems that compare the number of votes submitted by a securities intermediary to its ownership positions as reflected in DTC's records and notify that securities intermediary when it has submitted votes in excess of its ownership positions. The securities intermediary may then adjust its vote to reflect the correct number of votes before the service provider submits that vote to the vote tabulator.[65] The corrected information is then sent to the vote tabulator. The means by which securities intermediaries reconcile these differences has raised some concern regarding the accuracy of the vote, including whether the votes are being allocated to the beneficial owners in the correct amounts.

[65] SIFMA and individual broker-dealers have suggested several different methodologies as to how this may be accomplished, but we do not believe there is consensus among the industry participants or a standard operating procedure currently in place.

1. Imbalances in Broker Votes

For securities held at DTC, a DTC participant may vote only the number of securities held by that participant in its DTC account on the record date for a shareholder meeting. Sometimes the number of securities of a particular issuer held in the DTC participant's account will be less than the number of securities that the DTC participant has credited in its own books and records to its customers' accounts. Although there may be many reasons why the number of securities held by a broker-dealer at DTC does not match the total number of securities credited to the broker-dealer's customers' accounts, as discussed in more detail below, this situation principally arises in connection with lending transactions and "fails to deliver"[66] in the clearance and settlement system.

Because of the way broker-dealers track securities lending transactions,[67] if all of a broker-dealer's customers owning a particular issuer's securities actually voted, the broker-dealer may receive voting instructions for more securities than it is entitled to vote. Moreover, the existing clearance and settlement system was not designed to assign particular shares of a security to a particular investor, due to netting and holding securities in fungible bulk.[68] Thus, it is not currently possible to match a particular investor's vote to a specific securities position held at a securities depository. When a broker-dealer has fewer positions or shares reflected on the securities position listing[69] than it has reflected on its books and records, the broker-dealer must determine if and how it should allocate the votes it has among its customer and proprietary accounts and

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66 See Section III.A.1.b, below.

67 We understand that because securities are held in fungible bulk, broker-dealers typically do not allocate loaned securities to a particular account.

68 See Section IV.A.1, below.

69 See Section I.B.2.a, above, for a discussion of securities position listings.

then reconcile the actual voting instructions it receives with the number of securities the broker-dealer is permitted to vote with the issuer. Depending on a variety of factors, this process can lead to over-voting or under-voting by beneficial owners.

a. Securities Lending

When a customer purchases shares on margin, a portion of the securities in the customer's account may be used to collateralize the margin loan.[70] As part of the customer's margin agreement, the customer typically agrees to allow the broker-dealer to use those securities to raise money to fund the margin loan. Consequently, broker-dealers may lend out customers' margin securities. In addition, broker-dealers may enter into stock loan arrangements with investors (typically institutional investors or other broker-dealers) whereby the broker-dealer borrows the investors' fully-paid securities.[71]

Stock loan agreements typically transfer to the borrower the right to vote the borrowed securities.[72] Thus, for example, when an institutional investor, such as a fund, lends its portfolio securities to a borrower, the right to vote those securities also transfers to the borrower.[73] As a result, the institutional investor that lends its portfolio securities

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70 A broker-dealer must maintain possession and control of all fully-paid and excess margin securities. 17 CFR 240.15c3-3(b)(1).

71 When borrowing fully-paid securities, Exchange Act Rule 15c3-3(b)(3) requires, among other things, that a broker-dealer enter into a separate written agreement with the customer and provide the customer with a schedule of the securities actually borrowed as well as the collateral provided to the customer. 17 CFR 240.15c3-3(b)(3).

72 See Master Securities Lending Agreement at 6, available at www.sifma.org/services/stdforms/pdf/master_sec_loan.pdf.

73 If an institutional lender lends out portfolio securities after the record date for a particular shareholder vote, the lender would normally retain the right to vote the proxies for that particular shareholder vote.

generally loses its ability to vote those securities, unless and until the loan is terminated and the securities are returned before the record date in question.[74]

Even though a broker-dealer has the ability to lend its customers' margin securities pursuant to a stock loan agreement, because shares are held in fungible bulk, it may not be practical to inform a customer when an actual loan has been made and it may be unclear which lending investor has lost the right to vote. Therefore, a customer may expect to vote all of its securities because it does not necessarily know whether its securities have in fact been loaned. If the lending broker-dealer does not allocate a certain number of shares to a lending investor as having been borrowed, but instead sends a VIF indicating that the lending investor has the right to vote all of the securities credited to its account, including the loaned margin securities, both the lending and borrowing broker-dealers may submit voting instructions from two customers for a single share, which may give rise to an over-voting situation.

b. Fails to Deliver

An imbalance between a securities intermediary's position reflected on the securities position listing and the position reflected in its own books and records may also occur because of fails to deliver in the clearance and settlement system.[75] Every day the

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74 If the lending broker-dealer attempts to recall the loan, the borrowing broker-dealer may not be able to return the securities in a timely manner because, among other things, it may have reloaned or sold the security to another party and is unable to obtain shares to return to the lending broker-dealer.

75 Fails to deliver in all equity securities have declined significantly since the adoption of Interim Final Temporary Rule 204T in October 2008. See Amendments to Regulation SHO, Release No. 34-58773 (Oct. 14, 2008) [73 FR 61706]. See also Memorandum from the Staff Re: Impact of Recent SHO Rule Changes on Fails to Deliver, Nov. 4, 2009, available at http://www.sec.gov/spotlight/shortsales/oeamemo110409.pdf (stating, among other things, that the average daily number of aggregate fails to deliver for all securities decreased from 2.21 billion to 0.25 billion for a total decline of 88.5% when comparing a pre-Rule to post-Rule period); Memorandum from the Staff Re: Impact of Recent SHO Rule Changes on Fails to Deliver, Nov. 26, 2008, available at http://www.sec.gov/comments/s7-30-08/s73008-37.pdf; Memorandum from

NSCC, a registered clearing agency, nets each of its members' trades to a single buy or sell obligation for each issue traded.[76] Because NSCC acts as a central counterparty for its members' trades, its members are obligated to deliver securities to, and entitled to receive securities from, NSCC at settlement, and not to or from other broker-dealers. Although the delivery of securities usually occurs as expected on the settlement date, there are occasions when broker-dealers fail to make timely delivery, often for reasons outside of their control.[77]

Pursuant to NSCC rules, if an NSCC broker-dealer member "fails to deliver" the securities it owes to NSCC on the settlement date, NSCC will allocate this fail to one of many contra-side broker-dealers due to receive securities without trying to attribute the fail to the specific broker-dealer that originally traded with the broker-dealer that failed to deliver.[78] The broker-dealer to which the fail is allocated will not receive the securities and will not be credited with this position at DTC until delivery is actually made.

Even though the broker-dealer has not actually received the securities, the broker-dealer usually will credit its customers' accounts with the purchased securities on settlement date. If the broker-dealer's fail-to-receive position continues through the

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the Staff Re: Impact of Recent SHO Rule Changes on Fails to Deliver, Mar. 20, 2009, available at http://www.sec.gov/comments/s7-30-08/s73008-107.pdf.

76 NSCC nets securities in its "Continuous Net Settlement" system pursuant to rules and procedures approved by the Commission. For more information on NSCC's rules and procedures, see www.dtcc.com/legal/rules_proc/nscc_rules.pdf. See Section IV.A.1, below, for additional information about the role of NSCC.

77 For example, broker-dealers may fail to deliver securities because of: (1) delays by customers delivering to the broker-dealer the shares being sold; (2) a broker-dealer's inability to purchase or borrow shares needed for settlement; or (3) a broker-dealer's inability to obtain transfer of title of securities in time for settlement. For more information on fails to deliver in the U.S. clearance and settlement system, see Short Sales, Release No. 34-50103 (July 28, 2004) [69 FR 48008] and Amendments to Regulation SHO, Release No. 34-60388 (July 27, 2009) [74 FR 38266].

78 If a broker-dealer fails to deliver securities to NSCC, NSCC allocates this fail to a broker-dealer member that is due to receive the securities.

record date for a corporate election, DTC may not yet recognize the broker-dealer's entitlement to vote this position. As with loaned securities, the broker-dealer may still try to allocate votes to all of its customers that its records reflect as owning those securities, even though DTC has not credited the broker's account with those securities or with the corresponding right to vote those securities through DTC.

2. Current Reconciliation and Allocation Methodologies Used by Broker-Dealers to Address Imbalances

Because the ownership of individual shares held beneficially is not tracked in the U.S. clearance and settlement system, when imbalances occur, broker-dealers must decide which of their customers will be permitted to vote and how many shares each customer will be permitted to vote. Neither our rules nor SRO rules currently mandate that a reconciliation be performed, or the use of a particular reconciliation or allocation methodology. Broker-dealers have developed a number of different approaches as to how votes are "allocated" among customer accounts.[79] We understand that these approaches are often influenced by whether the broker-dealers' customers are primarily retail or institutional investors.

Most broker-dealers have adopted a reconciliation method to balance the aggregate number of shares they are entitled to vote with the aggregate number of shares

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[79] For more information on proxy processing and broker-dealer's reconciliation and allocation processes, see "Briefing Paper: Roundtable on Proxy Voting Mechanics," (May 24, 2007), available at http://www.sec.gov/spotlight/proxyprocess/proxyvotingbrief.htm ("Roundtable Briefing Paper"), or "Unofficial Transcript of the Roundtable Discussion on Proxy Voting Mechanics," (May 24, 2007), available at http://www.sec.gov/news/openmeetings/2007/openmtg_trans052407.pdf ("Roundtable Transcript"). The term "allocation" refers to the process by which a broker-dealer determines which of its customers will be allowed to vote and how many shares will be allotted to each of those customers.

credited to customer and proprietary accounts.[80] The primary reconciliation methods are: (1) pre-mailing reconciliation ("pre-reconciliation"); (2) post-mailing reconciliation ("post-reconciliation"); and (3) a hybrid form of the pre-reconciliation and post-reconciliation methods.[81] These methods are described in more detail below. If the broker-dealer finds that it is holding fewer shares at DTC than it has credited to customer and proprietary accounts, it may choose to give up its own votes, as represented by shares credited to its proprietary accounts, by allocating some or all of those votes to its customers, or it may choose to allocate to its customers only the voting rights attributable to customer accounts.

a. Pre-Reconciliation Method

A broker-dealer using the pre-reconciliation method compares the number of shares it holds in aggregate at DTC and elsewhere with its aggregate customer account position before it sends VIFs to its customers.[82] If the aggregate number of shares it holds is less than the number of shares the broker-dealer has credited to its customer accounts, then the broker-dealer will determine which of its customers will be permitted to vote and how many votes will be allocated to each of those customers. Broker-dealers using the pre-reconciliation method request voting instructions from their customers with respect to only those customer positions to which votes have been allocated. We understand that most broker-dealers give customers with fully-paid securities and excess margin securities first priority in the distribution of votes. It is also our understanding

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80 Not all broker-dealers have developed policies and procedures to address the reconciliation and allocation of votes among their customers because historically broker-dealers have usually had enough shares on deposit at DTC to provide a vote to all customers wanting to vote.

81 Roundtable Transcript, note 79, above.

82 Id.

that broker-dealers using the pre-reconciliation method tend to have more institutional customers than retail customers.[83]

Broker-dealers using the pre-reconciliation method have indicated that this method ensures that the votes customers cast will be counted.[84] On the other hand, given that some broker-dealers have estimated that only 20% to 30% of their retail customers usually vote, some believe that pre-reconciliation may result in an "under-vote" because investors allocated the ability to vote may not do so, and other investors who do vote may be allocated a number of votes fewer than the number of shares they beneficially own. In addition, some broker-dealers have indicated that the pre-reconciliation method is more expensive than the post-reconciliation method because post-reconciliation only needs to be performed when a broker-dealer receives voting instructions in excess of the number of shares that it holds.

b. Post-Reconciliation Method

A broker-dealer using the post-reconciliation method compares its aggregate position at DTC and elsewhere[85] with its actual aggregate customer account position only after receiving VIFs from its customers. Broker-dealers using the post-reconciliation method request voting instructions from their customers with respect to all shares credited to their customer accounts, including for those shares that may have been purchased on margin, loaned to another entity, or not received because of a fail to deliver.

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83 Id.

84 Id.

85 The aggregate number of shares the broker-dealer is entitled to vote may constitute more than just its position on deposit at DTC. For example, the broker-dealer may have additional securities on deposit at a foreign depository or in certificated form.

We understand that broker-dealers using the post-reconciliation method tend to have primarily retail customers rather than institutional customers.[86]

In the event that a broker-dealer receives voting instructions from its customers in excess of its aggregate securities position, the broker-dealer adjusts its vote count prior to casting its vote with the issuer. The manner in which the adjustment is made varies among broker-dealers. Some firms simply reduce the number of proprietary position votes cast. Others allocate fewer votes to customers with securities purchased on margin or on loan.

Because of the low level of participation by retail voters, some of the broker-dealers using the post-reconciliation method have indicated to the Commission that the number of over-vote situations is not a significant problem and can be addressed in a number of ways, including, but not limited to, the broker-dealer using its proprietary positions to redress any imbalance. The costs associated with the post-reconciliation method are generally considered to be less than those associated with the pre-reconciliation method because the broker-dealer does not have to go through the costly process of allocating votes among customers unless its customers remit VIFs for more shares than the broker-dealer is entitled to vote in the aggregate.

c. Hybrid Reconciliation Methods

Some broker-dealers have developed hybrid reconciliation methods that use aspects of both pre- and post-reconciliation methods. For example, in one hybrid reconciliation method, a broker-dealer will allocate votes to all of its customers with fully-paid securities but will also allow each margin account customer to instruct the

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86 Roundtable Transcript, note 79, above.

broker-dealer that it would like to vote its shares. The broker-dealer will allocate any shares not needed to cover fully-paid account holders to those margin customers who indicated they wanted to vote, thereby giving these margin customers priority over other margin customers.[87]

3. Potential Regulatory Responses

Broker-dealers have indicated to the Commission staff that most broker-dealers select an allocation and reconciliation method that best accommodates their particular customer base and best advances the firm's particular business strategy. For example, those firms focusing on retail customers generally will have more customer accounts owning smaller amounts of securities and casting relatively few votes and, as a result, may prefer the post-reconciliation method over the pre-reconciliation method.

The customers of a broker-dealer may not be aware of the allocation and reconciliation method used by the firm. We are interested in receiving views on whether it would be helpful to investors if broker-dealers publicly disclosed the allocation and reconciliation method used by the firm during each proxy season, as well as the likely effect of that method on whether the customers' voting instructions would actually be reflected in the broker-dealer's proxy sent to the vote tabulator. Such disclosure could be in writing and provided to customers upon opening an account and on an annual basis, and made available to the general public on the broker-dealer's Web site. This disclosure could help investors to decide if a particular broker-dealer's method suits their investment goals. Alternatively, we are interested in receiving views on whether it would be

[87] Id.

beneficial to investors if broker-dealers were required to use a particular reconciliation method.

Given the lack of empirical data on whether over-voting or under-voting is occurring and if so, to what extent, we also would like to receive views on whether investors, issuers, and the proxy system overall would benefit from having additional data from proxy participants regarding over-voting and under-voting to determine whether further regulatory action should be considered. This data would allow us to determine the scope of the problem, if any, and give us detailed information that would further assist us in determining whether current regulations are effective or additional regulation is appropriate. Such information may also indicate if one particular method is working better for investors and the market than other methods.

4. Request for Comment

- What are the advantages or disadvantages of the various methods of allocation or reconciliation currently used by securities intermediaries and the effectiveness of such methods?
- Is there any evidence, statistical, anecdotal or otherwise, of material over-voting or under-voting, and if so, what is the size and impact of over-voting or under-voting? For example, is there any evidence that over-voting or under-voting has determined the outcome of a vote or materially changed the voting results?
- Are there any concerns caused by over-voting or under-voting that are not described above? Are there particular concerns regarding the impact of either over-voting or under-voting with respect to specific types of voting

decisions, such as merger transactions, the election of directors where a majority vote is required, or shareholder advisory votes regarding executive compensation? What, if any, alternatives should we consider to the current system, and what would be the costs and benefits of any alternative process?

- Would requiring broker-dealers to disclose their allocation and reconciliation process adequately address the concerns related to over-voting and under-voting by beneficial owners?
- Would information about vote allocation and reconciliation methods be helpful to investors or adequately address any concerns related to those processes?
- Would a particular type of vote allocation and reconciliation method better protect investors' interests?
- Do the varying methods of vote allocation affect the potential to audit votes cast by beneficial holders?
- Should investors who have fully paid for their securities be allocated voting rights over those who purchased the securities on margin? Should beneficial holders be allocated voting rights over broker-dealer proprietary accounts?
- Should brokers be required to disclose the effect of share lending programs on the ability of retail investors to cast votes?
- Does the current system of settlement and clearance of securities transactions in the U.S. create any problems or inefficiencies in the proxy

process in regard to matters other than over-voting or under-voting? If so, what are they, and what steps should we consider in order to address them?

B. Vote Confirmation

1. Background

A number of market participants, including both individual and institutional investors, have raised concerns regarding the inability to confirm whether an investor's shares have been voted in accordance with the investor's instructions. As discussed more fully in Section II, beneficial owners cast their votes through a securities intermediary, which, in turn, uses a proxy service provider to collect and send the votes to the vote tabulator.[88] Beneficial owners, particularly institutional investors, often want or need to confirm that their votes have been timely received by the vote tabulator and accurately recorded. Similarly, securities intermediaries want to be able to confirm to their customers that their votes have been timely received and accurately recorded. Issuers also want to be able to confirm that the votes that they receive from securities intermediaries on behalf of beneficial owners properly reflect the votes of those beneficial owners. We understand that, on occasion, errors have been made when a third party fails to timely submit votes on behalf of its clients.[89]

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88 Some securities intermediaries may not have sufficient shares on deposit at DTC to allocate a vote to every share position credited to every customer's account. In those cases, the securities intermediary may have to allocate a specific number of votes to some customers that is fewer than the number of shares credited to those customers' accounts. See Section III.A, above, for a more in-depth discussion of why and how securities intermediaries reconcile and allocate votes to their customers.

89 See, e.g., Adam Jones, "Riddle of the Missing Unilever Votes Solved," Financial Times, Aug. 15, 2003; "Mum on a Recount," Pensions & Investments, Aug. 10, 2009, available at http://www.pionline.com/article/20090810/PRINTSUB/308109996; Meagan Thompson-Mann, Policy Briefing No. 3—Voting Integrity: Practices for Investors and the Global Proxy Advisory

The inability to confirm voting information is caused in part because no one individual participant in the voting process—neither issuers, transfer agents, vote tabulators, securities intermediaries, nor third party proxy service providers—possesses all of the information necessary to confirm whether a particular beneficial owner's vote has been timely received and accurately recorded. A number of market participants contend that some proxy service providers, transfer agents, or vote tabulators are unwilling or unable to share voting information with each other or with investors and securities intermediaries. There are currently no legal or regulatory requirements that compel these entities to share information with each other in order to allow for vote confirmations.

The inability to confirm that votes have been timely received and accurately recorded creates uncertainty regarding the accuracy and integrity of votes cast at shareholder meetings. At a time when votes on matters presented to shareholders are increasingly meaningful and consequential to all shareholders, this lack of transparency could potentially impair confidence in the proxy system.[90] Because of the inability to ascertain the integrity of the votes cast by beneficial owners, concerns have been raised by investors that it may be difficult to assess the accuracy of the current proxy system as a whole.

Industry, The Millstein Center for Corporate Governance and Performance, Mar. 2, 2009, at 10-11 ("Thompson-Mann Policy Briefing").

90 The Organisation of Economic Co-operation and Development ("OECD"), consisting primarily of jurisdictions with high income and developed markets, has voiced similar concerns about this lack of transparency in several jurisdictions and recommends addressing it through legal and regulatory changes. Corporate Governance: A Survey of OECD Countries (2004) ("OECD Survey").

2. Potential Regulatory Responses

In the Commission's view, both record owners and beneficial owners should be able to confirm that the votes they cast have been timely received and accurately recorded and included in the tabulation of votes, and issuers should be able to confirm that the votes that they receive from securities intermediaries/proxy advisory firms/proxy service providers on behalf of beneficial owners properly reflect the votes of those beneficial owners. We understand that there may be a number of operational and legal complexities with any proposed solution and that the costs and benefits associated with any options should be carefully weighed.

One possible solution may be for all participants in the voting chain to grant to issuers, or their transfer agents or vote tabulators, access to certain information relating to voting records, for the limited purpose of enabling a shareholder or securities intermediary to confirm how a particular shareholder's shares were voted. To protect the identities of objecting beneficial owners from issuers, a system could assign each beneficial owner a unique identifying code, which could then be used to create an audit trail from beneficial owner to proxy service provider to transfer agent/vote tabulator. Issuers (or their agents, such as transfer agents or vote tabulators) would, in turn, confirm to record owners, beneficial owners, and securities intermediaries upon request that any particular votes cast by them or on their behalf have been received and voted as instructed. This process could be fully automated such that a vote confirmation could be provided by the issuer (or its agent) to the record owner or, in the case of beneficial owners, to the securities intermediary or proxy service provider and sent by email to the beneficial owner.

Confirmation of the vote information may also facilitate the ability of market participants and state and federal regulatory authorities or courts to ascertain the accuracy of a particular election or the overall proxy system. Moreover, transparency of the process should promote investor confidence as well.

3. Request for Comment

- To what extent have shareholders had difficulty in confirming whether their submitted votes have been tabulated? To what extent have issuers had difficulty in determining whether the votes submitted by securities intermediaries/proxy advisory firms/proxy service providers accurately reflect the voting instructions submitted by beneficial owners?
- To what extent do investors believe that their votes have not been accurately transmitted or tabulated, and what is the basis for such belief? Is there sufficient information about the ways that investors actually place their votes, for example, by telephone, on paper, or via the Internet?[91] Do investors have concerns about whether the method they use to place their votes affects the likelihood that their vote will be accurately recorded?
- Should all participants in the voting chain grant access to their share voting records to issuers and their transfer agents/vote tabulators, for the limited purpose of enabling confirmation of a shareholder's vote? What are the benefits and costs associated with sharing such information?
- What is the best way to preserve any continuing anonymity of those investors who choose not to have their identities disclosed to the issuer?

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[91] See note 49, above.

- Would the creation of a unique identifier for each beneficial owner be feasible? Would such a system achieve the objective of allowing record owners and beneficial owners to confirm that their vote was cast in accordance with their instructions and confirm the number of shares cast on their behalf? What are the costs and benefits associated with such a system?
- Should issuers (and their agents) confirm to registered owners, beneficial owners, or securities intermediaries that the issuer has received and properly tabulated their votes? Should this confirmation be limited to an informal confirmation that votes have been counted, or should shareholders be able to obtain some form of proof that their votes have been counted? What type of documentation would constitute sufficient proof? What are the benefits and costs of such alternatives? Are there other steps that would enable beneficial owners to verify that their votes have been counted?
- Should investors also be able to obtain access to share voting records for the limited purpose of enabling an audit of the shareholder vote?
- Should issuers and securities intermediaries (and their agents) be required to reconcile and verify voting at the beneficial owner level? Would this be consistent with state law, which vests voting rights in the registered owner? Would other reconciliation and verification requirements be consistent with the purposes underlying state law?

- Should proxy participants periodically evaluate and test the effectiveness of their voting controls and procedures? If so, to whom should the results of these tests or the participants' conclusions on effectiveness be disclosed? Should disclosure be to the Commission, to clients, or also to the public?

C. Proxy Voting by Institutional Securities Lenders

Institutional securities lenders play a significant role in the proxy voting process, and we believe that it is important to evaluate the impact of their share lending on that process, and to consider ways in which the efficacy and transparency of share voting on the part of such institutions could potentially be improved. In particular, and as discussed below, we seek to examine whether decisions to recall loaned securities in connection with shareholder votes might be more timely and better informed. We also seek to examine whether increased disclosure of the votes cast by institutional securities lenders might improve the transparency of the voting process.

1. Background

Many institutions with investment portfolios of securities—such as insurance companies, pension funds, mutual funds, and college endowments—engage in securities lending to earn additional income on securities that would otherwise be sitting idle in their portfolios. When an institution lends out its portfolio securities, all incidents of ownership relating to the loaned securities, including voting rights, generally transfer to the borrower for the duration of the loan.[92] Accordingly, if the lender wants, or is

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92 See, e.g., Thomas P. Lemke et al., Regulation of Investment Companies at 8.02[1][2][vi][A] (2006) ("legal title to the [loaned] securities (along with voting rights and rights to dividends and distributions) passes to the borrower for the term of the loan; when the securities are returned, the

obligated, to vote the loaned securities, the lender must terminate the loan and recall the loaned securities prior to the record date.[93]

2. Lack of Advance Notice of Meeting Agenda

a. Background

Some institutional securities lenders have proxy voting policies that require the lender, in the event of a material vote, to get back the loaned securities in order to vote the proxies.[94] While issuers are required to provide information in the proxy statement about the matters to be voted on at a shareholder meeting, the proxy statement typically is not mailed out until after the record date. Therefore, those institutional lenders that desire, or are obligated, to vote proxies with respect to securities on loan in the event of a material vote face the challenge of learning what matters will be voted on at shareholder meetings sufficiently in advance of the record date so that the lenders can determine whether they want to get the loaned securities back before the record date.

We understand that some institutional securities lenders may try to obtain timely information about meeting agendas through a variety of informal means, including media reports. We are also told, however, that this informal process is not an effective substitute for a formal process that would alert securities lenders to the matters to be voted on at shareholder meetings in time to terminate the loan and receive the loaned

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fund regains title"). <u>See also</u> Master Securities Loan Agreement, note 72, above, at 7.1 (generally the borrower receives all the incidents of ownership of the borrowed securities while loan is open).

93 It is not typically feasible for the lender to retain proxy voting rights while the loan is open because the borrower typically transfers the loaned securities (for example, in a short sale), and the eventual transferee needs full right and title to the acquired securities.

94 For example, the Commission staff has agreed not to object if voting rights pass with the lending of securities provided that if the management of the lending fund has knowledge that a material event will occur with respect to a security on loan, the fund directors would be obligated to recall such loan in time to vote the proxies. <u>See, e.g.</u>, State Street Bank & Trust Company, SEC Staff No-Action Letter (Sept. 29, 1972).

securities. We understand that, in some instances, securities lenders learn of material votes too late to recall the loans to vote the proxies.[95]

b. Potential Regulatory Responses

In considering possible solutions, we note that, under Section 401.02 of the NYSE Listed Company Manual, NYSE-listed issuers must provide the exchange with notice of the record and meeting dates for shareholder meetings at least ten days prior to the record date for the meeting, unless it is not possible to do so. That notice must describe the matters to be voted upon at the meeting, unless it is accompanied by printed material being sent to shareholders which describes those matters. We understand, however, that this formal notice is not disseminated to the public and may not contain specific descriptions of all matters to be voted on at the meeting.

Consequently, one possible regulatory response is to ask the NYSE to revise its rules to require public dissemination of a notice, in advance of the record date, that contains information about the record and meeting dates as well as specific descriptions of all matters to be voted upon. Other SROs could also be asked to adopt similar rules. An alternative possibility is a requirement for all issuers subject to our proxy rules to disclose the agenda by public means, such as by filing a report on Form 8-K (or as an alternative to such a filing requirement, permitting the issuance of a press release or a posting on a corporate Web site).

In identifying these alternatives, we are mindful that it can be difficult for issuers to disclose complete meeting agendas in advance of the record date because the agenda may not be established at that time for a variety of reasons, including board consideration

95 See Roundtable Transcript, note 79, above.

of initiatives proposed by management and Commission staff review of no-action requests regarding Rule 14a-8 shareholder proposals.

c. **Request for Comment**

- Should the Commission propose a rule to require issuers to disclose publicly the meeting agenda sufficiently in advance of the record date to permit securities lenders to determine whether any of the matters warrant a termination of the loan so that they may vote the proxies? If so, how many days would constitute sufficient notice to the public?
- What are the advantages and disadvantages, practical and as a matter of policy, to requiring issuers to provide this advance notice to the public? For instance, would the issuer know, sufficiently in advance, all of the items to be on the agenda, particularly shareholder proposals which may be the subject of a request for no-action relief being considered by the Commission's staff?[96] How could such a requirement provide notice of contested matters and other non-management proposals to be considered at the meeting? Could we address concerns by allowing issuers to publish an agenda that is "subject to change"? If so, should we limit such changes to shareholder proposals for which the issuer is seeking no-action relief? How often does uncertainty about a meeting agenda preclude issuers from disclosing the agenda in sufficient time for shareholders to recall loans before the record date?

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96 When an issuer seeks to exclude a shareholder proposal submitted pursuant to Rule 14a-8, it must file its reasons with the Commission. 17 CFR 240.14a-8(j).

- Would a mechanism that alerts lending shareholders to meeting agendas well in advance of record dates have positive and desirable effects on the proxy solicitation system such that the Commission should encourage and facilitate this? Would such a mechanism increase the number of lenders recalling loans, and result in greater loan instability, with adverse effects on the capital markets? If there are competing interests, which should prevail, and why?
- How could an advance notice requirement be effected? Should the Commission propose rules applicable to all issuers subject to the proxy rules? Or, should the SROs amend or adopt listing standards requiring their listed issuers to provide advance notice to the public of record and meeting dates and specific descriptions of all matters to be voted on at the shareholder meeting?
- If we required advance notice, through what medium should such notice to shareholders be made? Should issuers be required to issue a press release or make a company Web site posting in addition to filing a notice with the Commission? Would such notice be sufficient for shareholders?
- We also request data regarding the recall of loaned securities by institutional shareholder lenders in order to vote the shares. Please include information regarding the circumstances in which the recalls did and did not occur, and whether the shares were ultimately voted.

3. Disclosure of Voting by Funds

a. Background

Management investment companies registered under the Investment Company Act (collectively, "funds") are required to disclose on Form N-PX how they vote proxies relating to portfolio securities.[97] In adopting this requirement in 2003, the Commission stated that "[i]nvestors in mutual funds have a fundamental right to know how the fund casts proxy votes on shareholders' behalf."[98] Indeed, the Commission required funds to disclose whether they cast their vote for or against management, in an effort to benefit fund shareholders by improving transparency and enabling them to monitor whether their funds approved or disapproved of the governance of portfolio companies.[99]

As noted above, when a fund lends its portfolio securities, all incidents of ownership relating to the loaned securities, including proxy voting rights, generally transfer to the borrower for the duration of the loan.[100] Accordingly, the fund generally loses its ability to vote the proxies of such securities, unless and until the loan is terminated and the securities are returned to the lender prior to the record date in question.

Currently, Form N-PX requires disclosure of proxy voting information "for each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the registrant was entitled to vote."[101] However, Form N-PX does not require disclosure of the number of shares for

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97 See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Release No. IC-25932 (Jan. 31, 2003) [68 FR 6564].

98 Id. at 6566.

99 Id. at 6565.

100 See note 92, above.

101 See Item 1 to Form N-PX. Form N-PX requires disclosure of the following: the name of the issuer of the portfolio security; the exchange ticker symbol of the portfolio security; the Council on Uniform Securities Identification Procedures (CUSIP) number for the portfolio security; the shareholder meeting date; a brief identification of the matter voted on; whether the matter was proposed by the issuer or by a security holder; whether the fund cast its vote on the matter; how

which proxies were voted, nor does the Form require disclosure with respect to portfolio securities on loan when, as is generally the case, the fund is not entitled to vote proxies relating to those securities. Thus, for example, if a fund lends out 99% of its portfolio holdings of XYZ Corporation and therefore votes only 1% of its holdings of XYZ, Form N-PX would disclose that the fund voted proxies with respect to shares of XYZ, but would not also disclose that the fund did not vote 99% of its holdings of XYZ because they were on loan.

b. Potential Regulatory Responses

We seek to examine whether Form N-PX should be amended to require disclosure of the actual number of votes cast by funds.

c. Request for Comment

- Should Form N-PX require disclosure of the actual number of shares voted? Should Form N-PX require disclosure of the number of portfolio securities for which a fund did not vote proxies because the securities were on loan or for other reasons?
- What would be the costs to funds of disclosing the actual number of proxy votes? What would be the costs to funds of disclosing the number of portfolio securities for which a fund did not vote proxies?

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the fund cast its vote (e.g., for or against proposal, or abstain; for or withhold regarding election of directors); and whether the fund cast its vote for or against management.

D. Proxy Distribution Fees

1. Background

One of the most persistent concerns that has been expressed to the Commission's staff, particularly by issuers, involves the structure and size of fees charged for the distribution of proxy materials to beneficial owners.

a. Current Fee Schedules

Pursuant to Exchange Act Rules 14b-1 and 14b-2, respectively, broker-dealers and banks must distribute certain materials received from an issuer or other soliciting party to their customers who are beneficial owners of securities of that issuer. These materials include proxy statements, information statements, annual reports, proxy cards, and other proxy soliciting materials.[102] A broker-dealer or bank does not need to satisfy this obligation, however, unless the issuer provides "assurance of reimbursement of the broker's or dealer's reasonable expenses, both direct and indirect," that the broker-dealer will incur in distributing the materials to its customers.[103]

In adopting these rules, we did not determine what constituted "reasonable expenses" that were eligible for reimbursement. Rather, the SROs submitted rule filings with us pursuant to Section 19(b) of the Exchange Act to establish these amounts.[104] Because SROs represent both issuers and broker-dealers, we believed that SROs would

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102 17 CFR 240.14b-1(b); 17 CFR 240.14b-2(b).

103 17 CFR 240.14b-1(c)(2); 17 CFR 240.14b-2(c)(2).

104 15 U.S.C. 78s(b). See, e.g., Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to Proposed Rule Change Relating to a One-Year Pilot Program for Transmission of Proxy and Other Shareholder Communication Material, Release No. 34-38406 (Mar. 14, 1997) [62 FR 13922]. We note that, in approving a rule filing, we must find that such filing is consistent with the Exchange Act. For example, Section 6(b)(4) of the Exchange Act requires that the rules of an exchange "provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities." 15 U.S.C. 78f(b)(4).

be best positioned to "make a fair evaluation and allocation" of the costs associated with the distribution of shareholder materials.[105] Accordingly, SRO-adopted rules, approved by the Commission, establish the maximum amount that an SRO member may receive for soliciting proxies from, and distributing other issuer materials to, beneficial owners on behalf of issuers.[106]

Since 1937, the New York Stock Exchange has required issuers, as a matter of policy, to reimburse its members for out of pocket costs of forwarding proxy materials.[107] Reimbursement rates were formally established by rule in 1952, and have been revised periodically since then.[108] Today, NYSE Rules 451 and 465 establish the fee structure for which a NYSE member organization may be reimbursed[109] for expenses incurred in connection with the forwarding of proxy materials, annual reports, and other materials to beneficial owners.[110] The NYSE initially proposed this fee structure as part of a one-year pilot program, which elicited a number of comments before the Commission approved the pilot program in 1997.[111] The pilot program was extended several times, during

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105 See Release No. 34-38406, note 104, above.

106 See text accompanying notes 116 to 120, below.

107 See Report and Recommendations of the Proxy Working Group to the New York Stock Exchange ("Proxy Working Group Report"), June 5, 2006, available at http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf, at 23.

108 Id.

109 It should be noted that the NYSE fee schedule under Rule 451 for expenses incurred in connection with proxy solicitations is the same as the fee schedule for expenses incurred in mailing interim reports or other material pursuant to Rule 465. For purposes of this release, references to fees will cite to NYSE Rule 465. Pursuant to Rule 465, member organizations are entitled to receive reimbursement for all out of pocket expenses, including clerical expenses as well as actual costs, including postage costs, the cost of envelopes, and communication expenses incurred in receiving voting returns either electronically or telephonically. See NYSE Rule 465(2) and Supplementary Material to Rule 465.20.

110 The vast majority of firms that distribute issuer material to beneficial owners are reimbursed at the NYSE fee schedule rates because most of the brokerage firms are NYSE members or members of other exchanges that have rules similar to the NYSE's rules.

111 See Release No. 34-38406, note 104, above.

which time the NYSE participated in the Proxy Voting Review Committee, which was established to review the pilot fee structure.[112] In 2002, the NYSE proposed to implement the fee structure on a permanent basis, with some changes, in light of the recommendations of the Proxy Voting Review Committee.[113] Some commentators raised concerns about the amount of the fees and the absence of competition that might help determine the appropriate level for those fees.[114] In approving the fee structure on a permanent basis, we stated that we expected the NYSE to monitor the fees to confirm that they continued to relate to "reasonable expenses."[115]

Currently, the rates set by the NYSE for the forwarding of an issuer's proxy materials include:[116]

- A "Base Mailing Fee" of $0.40 for each beneficial owner account when there is not an opposing proxy (the "Base Mailing Fee"). This fee applies for each set of proxy materials, regardless of whether the materials have been mailed or the mailing has been suppressed or eliminated.
- An "Incentive Fee" of $0.25 per beneficial owner account for issuers whose securities are held by many beneficial owners and $0.50 per

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112 See Order Approving Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Amending Its Rules Regarding the Transmission of Proxy and Other Shareholder Communication Material and the Proxy Reimbursement Guidelines Set Forth In Those Rules, and Requesting Permanent Approval of the Amended Proxy Reimbursement Guidelines, Release No. 34-45644 (Mar. 25, 2002) [67 FR 15440] ("NYSE Fee Structure Order").

113 Id.

114 Id. See also Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to Proposed Rule Change Relating to the Reimbursement of Member Organizations for Costs Incurred in the Transmission of Proxy and Other Shareholder Communication Material, Release No. 34-41177 (Mar. 16, 1999) [64 FR 14294].

115 See NYSE Fee Structure Order, note 112, above.

116 See NYSE Supplementary Material to Rule 465.20.

account for issuers with few beneficial owners.[117] This fee, which is in addition to the Base Mailing Fee, applies when the need to mail materials in paper format has been eliminated, for instance, by eliminating duplicative mailings to multiple accounts at the same address.[118]

- A "Nominee Coordination Fee" of $20 per "nominee" – i.e., securities intermediaries that are either registered holders or identified on the DTC securities position listing – which is paid to a proxy service provider that coordinates the mailings for multiple securities intermediaries.
- An additional "Nominee Coordination Fee" of $0.05 per beneficial owner account for issuers whose securities are held by many beneficial owners[119] and $0.10 per account for issuers with few beneficial owners.[120]

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117 The Incentive Fee is $0.25 for each account for issuers whose shares are held in at least 200,000 nominee accounts, and $.50 for each account for issuers whose shares are held in fewer than 200,000 accounts. According to the NYSE, the cost to service large issuers, i.e., issuers whose shares are held in at least 200,000 nominee accounts, is less than the cost to service small issuers because of economies of scale, which justifies a smaller Incentive Fee for large issuers. See NYSE Fee Structure Order, note 112, above.

118 NYSE Rule 465 includes the following examples as being eligible for the Incentive Fee: "multiple proxy ballots or forms in one envelope with one set of material mailed to the same household, by distributing multiple proxy ballots or forms electronically thereby reducing the sets of material mailed, or by distributing some or all material electronically."

119 The per-account Nominee Coordination Fee is $0.05 for each account for each issuer's securities for issuers whose shares are held in at least 200,000 beneficial owner accounts held by nominees, and $.10 for each account for each issuer's securities for issuers whose shares are held in fewer than 200,000 beneficial owner accounts held by nominees. See NYSE Fee Structure Order, note 112, above. According to the NYSE, as with Incentive Fees, the cost to service large issuers is less than the cost to service small issuers because of economies of scale, which justifies a smaller Nominee Coordination Fee per account for large issuers. Id.

120 For example, if an issuer's securities are held in 10,000 beneficial owner accounts holding in street name, and those accounts are divided among ten securities intermediaries, the fees discussed above would be assessed as follows:

- Base Mailing Fee of 10,000 accounts x $0.40 per account, or $4,000;Incentive Fee of 5,000 accounts suppressed x $0.50 per account, or $2,500 (assuming 50% of the accounts are eligible for the incentive fee);
- Nominee Coordination Fee of 10 securities intermediaries x $20 per intermediary, or $200; and

While a member organization, such as a securities intermediary, may seek reimbursement for less than the approved rates, it may not seek reimbursement for an amount higher than the approved rates listed in Rule 465, or for items or services not enumerated in Rule 465, "without the prior notification to and consent of the person soliciting proxies or the issuer."[121]

When the fees were approved in 2002, we expected the NYSE "to continue its ongoing review of the proxy fee process, including considering alternatives to SRO standards that would provide a more efficient, competitive, and fair process."[122] We also indicated that market participants should consider ways in which market forces could determine reasonable rates of reimbursement, rather than have these rates be set by the NYSE under its rules.[123]

In 2006, the Proxy Working Group considered the NYSE's current fee structure and indicated that Rule 465's fees "may be expensive to issuers but generally result[] in shareholders receiving and being able to vote proxies in a timely manner. This is an important benefit of the current system."[124] The Proxy Working Group also noted, however, that "issuers and shareholders deserve periodic confirmation that the system is performing as cost-effectively, efficiently and accurately as possible, with the proper level of responsibility and accountability in the system."[125] The Proxy Working Group also recommended that the NYSE should "continue to explore alternative systems...such

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- Additional Nominee Coordination Fee of 10,000 accounts x $0.10 per account, or $1,000.

121 See NYSE Supplementary Material to Rule 465.23.

122 See NYSE Fee Structure Order, note 112, above. In the NYSE Order, we also stated that we expected NYSE to "periodically review these fees to ensure they are related to 'reasonable expenses . . . in accordance with the [Exchange] Act, and propose changes where appropriate." Id.

123 Id.

124 Proxy Working Group Report, note 107, above, at 5.

125 Id., at 26.

that a competitive system, with fees set by the free market, could eventually succeed the current system."[126] The Proxy Working Group recommended that the NYSE engage an independent third party to analyze and make recommendations regarding the structure and amount of fees paid under Rule 465 and to study the performance of the proxy service provider that currently has the largest market share and the business process by which the distribution of proxies occurs. To date, this review has not been done. Subsequently, the Proxy Working Group's Cost and Pricing Subcommittee considered the changes brought about through the notice and access model and decided that the notice and access fees were not covered under current NYSE fee rules and concluded that they should allow participants to negotiate their own fees.[127]

After the NYSE fee structure for proxy distribution was established on a permanent basis in 2002, other SROs adopted similar rules. For example, the NYSE Amex LLC ("Amex") and the Financial Industry Regulatory Authority, Inc. ("FINRA") revised their rules (Amex Rule 576, Amex Section 722 of the Amex Company Guide, and NASD IM-2260, respectively) to adopt similar provisions.[128]

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126 Id., at 29.

127 See August 27, 2007 Addendum to the Report and Recommendations of the Proxy Working Group to the New York Stock Exchange dated June 5, 2006 ("Proxy Working Group Addendum"), available at http://www.nyse.com/pdfs/PWGAddendumfinal.pdf.

128 See Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the American Stock Exchange LLC Amending Exchange Rules 576 and 585, and Sections 722 and 725 of the Amex Company Guide, Release No. 34-46146 (June 28, 2002) [67 FR 44902] and Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to an Amendment to NASD Interpretive Material 2260, Release No. 34-47392 (Feb. 21, 2003) [68 FR 9730]. NASD Rule 2260 and NASD IM-2260 were recently renumbered as FINRA Rule 2251 in the Consolidated FINRA Rulebook. See Order Granting Approval of Proposed Rule Change to Adopt FINRA Rule 2251 (Forwarding of Proxy and Other Issuer-Related Materials) in the Consolidated FINRA Rulebook, Release No. 34-61052 (Nov. 23, 2009) [74 FR 62857].

b. Notice and Access Model

Neither the NYSE nor any other SRO has established maximum fees that member firms may charge issuers for deliveries of proxy materials using the notice and access method. The majority of broker-dealers have contracts with one proxy service provider to distribute proxies to beneficial owners.[129] If an issuer elects the "notice-only" delivery option for any or all accounts, that proxy service provider currently charges an "Incremental Fee," ranging from $0.05 to $0.25 per account for positions in excess of 6,000,[130] in addition to the other fees permitted to be charged under NYSE Rule 465. This Incremental Fee is charged to all accounts, even if the issuer has elected to continue "full set" delivery to some accounts. Several issuers have expressed concerns about these fees associated with the notice and access model.

c. Current Practice Regarding Fees Charged

As noted above, broker-dealers generally outsource their delivery obligations to proxy service providers.[131] The proxy service provider enters into a contract with the broker-dealer and acts as a billing and collection agent for that broker-dealer. As such, the proxy service provider bills issuers on behalf of the broker-dealer with which it has contracted, collects the fees from the issuer to which the broker-dealer is entitled pursuant

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129 Broadridge, as the service provider for most U.S. broker-dealers holding customer accounts, distributes the vast majority of proxy mailings to beneficial owners. See Proxy Working Group Report, note 107, above, at 24 ("ADP [(now Broadridge) is] the agent for almost all banks and brokerage houses.").

130 The Incremental Fee for 1 to 6,000 positions is $1,500. Above 6,000 positions, the fee is charged on a per-account basis, and varies according to the number of positions. As such, the Incremental Fee ranges from $.25 per account for 6,001 to 10,000 positions to $.05 per account for greater than 500,000 positions. See Broadridge Fee Schedule, at http://www.broadridge.com/notice-and-access/pdfs/Reference_Rev1_31.pdf.

131 See NYSE Fee Structure Order, note 112, above. According to the NYSE, this shift was attributable to the fact that member firms believed that proxy distribution "was not a core broker-dealer business and that capital could be better used elsewhere." Id.

to SRO rules, and pays to the broker-dealer any difference between the fee that the broker-dealer is entitled to collect and the amount that the broker-dealer has agreed to pay the proxy service provider for its services.[132]

It is our understanding that Broadridge currently bills issuers, on behalf of its broker-dealer clients, the maximum fees allowed by NYSE Rule 465.[133] However, we understand that the fees that Broadridge charges its large broker-dealer clients for its services sometimes are less than the maximum NYSE fees charged to issuers on the broker-dealers' behalf, resulting in funds being remitted from Broadridge to a subset of its broker-dealer clients. This practice raises the question as to whether the fees in the NYSE schedule currently reflect "reasonable reimbursement." While the issuer pays the proxy distribution fees, the issuer has little or no control over the process by which the proxy service provider is selected, the terms of the contract between the broker-dealer and the proxy service provider, or the fees that are incurred through the proxy distribution process.

Several other issues concerning the appropriateness of fees have also been raised in recent years. For example, it is our understanding that, once a paper mailing is suppressed, the securities intermediary, or its agent, collects the Incentive Fee, not only for the year in which the shareholder makes that election, but also for every subsequent year, even though the continuing role of the securities intermediary, or its agent, in eliminating these paper mailings is limited to keeping track of the shareholder's

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132 See Release No. 34-38406, note 104, above. See also Broadridge Form 10-K for the fiscal year ended June 30, 2009, at 4.

133 See Broadridge Fee Schedule, note 130, above.

election.[134] Further, it is our understanding that, with respect to certain managed accounts, where hundreds or thousands of beneficial owners may delegate their voting decisions to a single investment manager, the Base Mailing Fee and the Incentive Fee are assessed for all accounts, even though only one set of proxy materials is transmitted to the investment manager.[135]

In summary, many issues have been raised about fees, focusing mostly on whether the current fee structure for delivering proxy materials to beneficial owners reflects reasonable rates of reimbursement.

2. Potential Regulatory Responses

We have previously recognized the potential benefits of allowing the marketplace, rather than SRO rules and guidelines, to determine reasonable rates of reimbursement for the distribution of proxy materials. As noted above, at the time of adoption of the current fee structure, we did not expect that the discussion of reasonable rates of reimbursement would end. Rather, we noted that market forces should ultimately determine competitive and reasonable rates of reimbursement, and urged the NYSE to identify ways to achieve this goal, consistent with the continued protection of shareholder voting rights in a competitive marketplace for proxy distribution.[136] While the Proxy Working Group did

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[134] This Incentive Fee is intended to encourage securities intermediaries to reduce proxy distribution costs on behalf of issuers because intermediaries otherwise may have no motivation to reduce an issuer's forwarding costs. See SIFMA, Report on the Shareholder Communications Process with Street Name Holders, and the NOBO-OBO Mechanism (June 10, 2010) ("SIFMA Report"), at 14 (describing categories of ongoing costs of maintaining current e-mail addresses and related databases and systems), available in the public comment file to this release.

[135] See letter from Thomas L. Montrone of The Securities Transfer Association to Chairman Mary Schapiro, dated June 2, 2010 (stating that "We believe that many issuers are being assessed unreasonable fees under Rule 465 related to share ownership in separate managed accounts ("SMAs") in which the investor has delegated responsibility for management of the account and is not being provided with any proxy materials"), available in the public comment file to this release.

[136] See NYSE Fee Structure Order, note 112, above.

suggest ways to re-evaluate the NYSE's current fee structure, such as conducting "cost studies, commission audits and surveys of various constituencies involved,"[137] to date those suggestions have not been implemented. A proxy distribution process that fosters competition could give issuers, which are responsible for reimbursing only reasonable proxy distribution costs, more control over that process and remove the Commission and SROs from the business of setting rates. However, we understand that, without a competitive market, there may be a continued need for regulated fees.

In addition, we recognize the importance of maintaining a proxy distribution system that is efficient, reliable, and accurate. We note that various groups have previously attested to the efficiency, reliability, and accuracy of the current proxy distribution system.[138] However, given developments in the securities market overall and proxy solicitation rules, such as the notice and access model, it appears to be an appropriate time for SROs to review their existing fee schedules to determine whether they continue to be reasonably related to the actual costs of proxy solicitation.

One alternative that has been suggested by a commentator is the creation of a central data aggregator that is given the right to collect beneficial owner information from securities intermediaries, but is required to provide that information to any agent designated by the issuer.[139] The aggregator would be entitled to structured compensation

137 See Proxy Working Group Report, note 107, above, at 26-27.

138 See, e.g., letter from Donald D. Kittell, Securities Industry Association, to Nancy M. Morris, Secretary, Commission, dated Feb. 13, 2006 ("The current system for delivering proxies to 80 percent of shareholders – those holding in 'street name'—has proven to be very efficient and cost-effective.") available in the public comment file to this release. See also Proxy Working Group Report, note 107, above, at 25 (citing to letter from Richard H. Koppes, Facilitator, Proxy Voting Review Committee, to Sharon Lawson, Senior Special Counsel, Commission, dated Feb. 28, 2002).

139 See Shareholder Communications Coalition, Public Issuer Proxy Voting: Empowering Individual Investors and Encouraging Open Shareholder Communications (Aug. 4, 2009) ("SCC Discussion Draft"), at 6, available in the public comment file to this release.

for its activities. This could create competition among service providers for the distribution of the proxy materials by making the beneficial owner information available to all service providers, allowing them to compete in providing services to forward proxy materials. This would also place the choice of proxy service provider in the hands of the entity that must pay for the distribution—the issuer—rather than the securities intermediary, which has no incentive to reduce costs.

Some of the other potential regulatory responses discussed in this release also would affect the current system of distributing proxy materials and, therefore, the process of setting proxy distribution fees. For instance, adopting a system under which securities intermediaries grant proxies to underlying beneficial owners (as discussed in Section III.A) would permit issuers to negotiate fees and services with proxy service providers because the issuers would be directly soliciting proxies from those beneficial owners.

3. Request for Comment

- Does the current fee/rebate structure reflect reasonable expenses? Why or why not? If not, how should these rates be revised?
- Should the fee structure allow for reimbursement of the Incentive Fee on an ongoing basis once the paper mailings have already been eliminated?
- How are proxy distribution fees billed with respect to separately managed accounts? Should certain kinds of accounts, such as separately managed accounts, where multiple beneficial owners may delegate their voting decisions to a single investment manager, be eligible for different treatment under the current fee structure?

- Are separately managed accounts different from "wrap" accounts for which issuers may not be charged suppression fees for providing proxy communication services to holders of WRAP accounts?[140]
- Does the current fee structure discourage issuers from communicating with beneficial owners beyond delivery of the required proxy materials?
- Should there be an independent third-party audit of the current fee structure, as recommended by the Proxy Working Group?
- Do broker-dealers using a proxy service provider incur costs that justify rebates from the proxy service provider? If so, what are the costs, can they be quantified, and are they commensurate with the payments received from the proxy service provider? Do these costs exist only for larger broker-dealers or for broker-dealers of all sizes? Should the current rebates between Broadridge and larger broker-dealers be permitted under the current fee structure? Should current contractual arrangements between proxy service providers and their clients affect the determination of whether fees are fair and reasonable?
- Currently, SRO rules do not set rates for reimbursement of expenses associated with the notice and access model. In the absence of SRO rules, on what basis do market participants currently determine whether the reimbursement of expenses associated with the notice and access model is, in fact, reasonable?

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140 It is our understanding that a wrap account is a certain type of account that is managed by an outside investment manager.

- Should the current fee structure that is set forth in SRO rules be revised to include fees for notice and access delivery? If so, what fees for the notice and access model might constitute "reasonable reimbursement?"
- Does the current proxy distribution system – in which the proxy service provider is selected by a broker-dealer but paid by the issuer – create a lack of incentives to reduce costs for issuers? Should the issuer have more control over the selection and payment of the proxy service provider, and if so, what alternatives to the current system would facilitate this? What are the potential benefits and drawbacks of such alternatives?
- What factors are currently affecting the level of competition in the market for proxy service providers and their fees? What principles should guide the Commission's current consideration of competition among proxy service providers? Would multiple competing service providers affect the quality of service?
- What steps would be necessary to enable prices to be based on competitive market forces? What are the potential benefits and drawbacks of moving to a system where prices are determined by competitive market forces? What effect, if any, would this have in terms of accuracy, accountability, reliability, cost, and efficiency of the proxy distribution system? Would a market-based model increase or decrease costs for issuers? Would cost increases or decreases be more likely for small to midsize issuers?
- If issuers were able to solicit proxies directly from beneficial owners, what effect would that likely have on proxy distribution costs? Would costs be

reduced through the introduction of competition and better alignment of economic incentives? Or, could the loss of economies of scale increase costs? Would each issuer likely negotiate fees on its own with a proxy service provider? Would the impact be different for large, medium, or small issuers?

- What are the practical and legal implications of deregulating fees in light of the existing contracts between proxy service providers and broker-dealers? For example, would these contracts need to be re-negotiated?
- What are the potential merits and drawbacks of having a central data aggregator collect beneficial owner information from securities intermediaries? How would reimbursement to the aggregator, as the distributor of information, be determined?
- Would changes to the OBO/NOBO mechanism, or the creation of a central data aggregator, encourage competition in the proxy distribution sector? Would competition increase or lower costs? Would competition increase or decrease accountability?
- A number of investors have complained about the services of proxy service providers (and transfer agents performing similar functions). How are investors' interests addressed, if at all, in the selection of proxy service providers? Are the interests of investors in this process given adequate weight?

IV. Communications and Shareholder Participation

We first examine a number of concerns relating to the ability of issuers to communicate with shareholders, the level of shareholder participation in the proxy voting process, and the ability of investors to obtain and evaluate information pertinent to voting decisions. Because of the importance of shareholder voting, as discussed above, we seek additional information about ways in which issuer communications with shareholders, shareholder participation and shareholder use of information might be improved.

A. Issuer Communications with Shareholders

1. Background

The first area of concern that we address arises out of the practice of holding securities in street name – that is, interposing securities intermediaries between issuers and the beneficial owners of their securities. This practice developed in order to facilitate the prompt and accurate processing of an increasingly large volume of securities transactions.[141] The efficiency of the clearance and settlement system in the U.S. is due in large part to the ability to "net" transactions, whereby contracts to buy or sell securities between broker-dealers are replaced with net obligations to a registered clearing agency, the National Securities Clearing Corporation ("NSCC"). To make netting possible, securities must be held in fungible bulk at DTC.

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141 For a history of the U.S. shareholder system, see Alan L. Beller & Janet L. Fisher, The OBO/NOBO Distinction in Beneficial Ownership: Implications for Shareowner Communications and Voting (February 2010), available at http://www.cii.org/UserFiles/file/CII%20White%20Paper%20-%20The%20OBO-NOBO%20Distinction%20in%20Beneficial%20Ownership%20February%202010.pdf, at 8-10. This report (the "CII OBO/NOBO Report") was published by the Council of Institutional Investors.

There is broad consensus[142] that the enormous volume of transactions cleared and settled in the U.S., which currently involve transactions valued at over $1.48 quadrillion annually,[143] requires a centralized netting facility (i.e., NSCC) and a depository (i.e., DTC) that facilitates book-entry settlement of securities transactions. It is our understanding that this approach to clearance and settlement has produced significant efficiencies, lower costs, and risk management advantages. At the same time, however, the practice of holding securities in fungible bulk has made it more difficult for issuers to identify their beneficial owners and to communicate directly with them.

In light of recent developments in corporate governance, including the elimination of the broker discretionary vote on uncontested elections of directors, commentators have claimed a greater need for issuers to be able to communicate with their shareholders.[144] These commentators have argued that the number of contested issues in shareholder meetings has increased, that voting outcomes are under more pressure, and that, as a result, certain changes should be made to our rules in order to facilitate communications by issuers with their beneficial owners.[145] More broadly, commentators have questioned

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142 See "Recommendations for Securities Settlement Systems," CFSS/IOSCO Task Force (Nov. 2001) and "Global Clearing and Settlement, A Plan of Action," published by the Group of Thirty ("G-30") (Jan. 30, 2003).

143 See http://www.dtcc.com/about/business/statistics.php.

144 See Proxy Working Group Report, note 107, above, at 22 (discussing comments received with respect to a then-proposed amendment, which was recently adopted, to Rule 452 eliminating broker-dealer voting in the election of directors).

145 See, e.g., CII OBO/NOBO Report, note 141, above, at 11 ("Recent developments in corporate governance will place more pressure on voting outcomes and increase the need for both companies and shareowners to have an effective and reliable framework for communications."); letter from Shareholder Communications Coalition to Chairman Mary Schapiro (Aug. 4, 2009), available at http://www.shareholdercoalition.com/SCCLettertoSECChairmanMarySchapiroAug2009.pdf.

whether the current system of share ownership and the Commission's communications and proxy rules adequately serve the needs of investors and issuers.[146]

The history of our efforts to address the impediments to communication associated with our securities ownership system goes back more than three decades. In 1976, we reported to Congress on the effects of the practice of holding securities in street name.[147] While we concluded that the practice of registering securities in nominee (that is, DTC or a securities intermediary) and street name was consistent with the purposes of the Exchange Act, we recognized that issuers were experiencing difficulties in communicating with their shareholders who hold securities in nominee and street name. In an effort to enhance communication, we revised the proxy rules to require issuers, as more fully described above, to do the following:

- Inquire of securities intermediaries whether other persons beneficially owned the securities they held of record; and
- Supply securities intermediaries with a sufficient number of sets of proxy materials to forward to beneficial owners.[148]

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146 In 2004, the BRT Petition urged the Commission "to conduct a thorough review of the current shareholder communications system." BRT Petition, note 8, above. The petition recommended that "the Commission require brokers and banks to provide issuers with contact information for all beneficial owners and permit the direct mailing of all communications (including proxy materials) to beneficial owners." Id. See also Marcel Kahan & Edward B. Rock, The Hanging Chads of Corporate Voting, 96 Georgetown Law Journal 1227 (2008); J. Robert Brown Jr., The Shareholder Communication Rules and the Securities and Exchange Commission: An Exercise in Regulatory Utility or Futility, 13 Journal of Corporation Law 683 (1988); David C. Donald, The Rise and Effects of the Indirect Holding System: How Corporate America Ceded Its Shareholders to Intermediaries (Sept. 26, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017206.

147 Street Name Study, note 13, above.

148 Notice of Adoption of Amendments to Rules 14a-3, 14c-3 and 14c-7 under the Exchange Act to Improve the Disclosure in, and the Dissemination of, Annual Reports to Security Holders and to Improve the Dissemination of Annual Reports on Form 10-K or 12-K Filed with the Commission Under the Exchange Act, Release No. 34-11079 (Oct. 31, 1974) [39 FR 40766]. These requirements, which were originally included in Rule 14a-3(d), are currently set forth in Rule 14a-13 [17 CFR 240.14a-13]. Facilitating Shareholder Communications, Release No. 34-22533 (Oct.

To promote direct communication between issuers and their beneficial owners, we adopted rules in 1983, effective in 1985, to require broker-dealers and banks to provide issuers, at their request, with lists of the names and addresses of beneficial owners who did not object to having such information provided to issuers.[149] These owners are often referred to as "non-objecting beneficial owners" or "NOBOs." When a beneficial owner objects to disclosure of its name and address to the issuer – often referred to as "objecting beneficial owners" or "OBOs" – the beneficial owner may be contacted only by the securities intermediary (or the intermediary's agent) with the customer relationship with the beneficial owner.[150] According to one estimate, 70% to 80% of all public issuers' shares are held in street name, and 75% of those shares, or 52% to 60% of all shares, are held by OBOs.[151] It is our understanding that some types of

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15, 1985) [51 FR 44276]. Based in part on the recommendation of the Street Name Study, we adopted additional rules in 1977 facilitating the transmission of proxy materials from issuers to beneficial owners. Requirements for Dissemination of Proxy Information to Beneficial Owners by Issuers and Intermediary Broker-Dealers, Release No. 34-13719 (July 5, 1977) [42 FR 35953].

149 See Facilitating Shareholder Communications Provisions, Release No. 34-20021 (July 28, 1983) [48 FR 35082]. Exchange Act Rule 14a-13(b)(5) enables an issuer to obtain a list of its NOBOs only, which means that broker-dealers and banks must classify their beneficial owners as either objecting or non-objecting beneficial owners, based on the investor's election. A requesting issuer must reimburse the intermediaries for their reasonable expenses in preparing the NOBO list. 17 CFR 240.14a-13(b)(5). The NYSE and other exchanges establish a per-holder fee that member brokers can charge for preparation of the NOBO list. E.g., NYSE Rule 465. Notwithstanding these limitations on the fees, issuers, particularly those with large shareholder bases, have indicated that the cost to obtain such lists can be prohibitive.

150 See 17 CFR 240.14b-1(b)(3)(i). Several commentators have indicated that, in a number of foreign jurisdictions, public issuers have the right to learn the identity of individuals and institutions with voting rights or beneficial owner interests in their shares. See, e.g., BRT Petition, note 8, above; Kahan, note 146, above; Donald, note 146, above.

151 Proxy Working Group Report at 10-11, note 107, above.

large institutional investors, such as mutual funds[152] and retirement plans, often choose OBO status.[153]

We understand that there are concerns about the cost and efficiency of the current system of communications between issuers and investors, including the following:[154]

- Issuers have indicated to the staff that the majority of their street name securities are held by OBOs through securities intermediaries, making it very difficult to determine the identity and holdings of their investors. Issuers believe that the recent changes in corporate governance, including the move to majority voting of directors, the elimination of broker discretionary voting in uncontested director elections, and a possible drop in retail voting percentages,[155] call for more direct communication between issuers and their shareholders. These communications may include using a proxy solicitor to contact shareholders by telephone. However, an issuer cannot make these direct appeals for shareholders to

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152 Although mutual funds disclose their securities holdings on Forms N-Q and N-CSR, those disclosures are made as of the end of the quarter, which may not coincide with the record date used to determine shareholders entitled to vote at a meeting.

153 One recent report states that while "73% of retail shareholders are NOBOs, . . . [m]ost institutional shareholders—about 71%--are OBOs, accounting for about 91% of all institutionally held shares." SIFMA Report, note 134, above, at 7.

154 Concerns about whether or not to disclose shareholder identities are shared by regulators in several jurisdictions. For example, in Canada, companies are under no obligation to send proxy materials to shareholders who do not disclose their underlying identity. See OECD Survey, note 90, above. In the United Kingdom, companies have the right to ask any person whom the company knows or has reasonable cause to believe has an interest in its shares to declare that interest. UK Companies Act 2006 – Section 793: Notice by company requiring information about interests in its shares, available at (http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_45) The failure to do so may enable the company to apply for a court order directing that the shares in question be subject to certain restrictions involving voting rights, transfers and other limitations. UK Companies Act 2006 – Sections 794 and 797. Given that shareholders have the right to dismiss the board at any time in the United Kingdom, companies generally believe it is important that the board know who its shareholders are and pay attention to what they want. Thus, the company should be entitled to know who owns its shares in order to ensure accountability in both directions.

155 It is unclear whether such a drop has occurred. See note 196 and accompanying text, below.

participate in the issuer's corporate governance if it does not know the identity of those shareholders.

- Issuers also have indicated to the staff that they face considerable expense in communicating with beneficial owners, either OBOs or NOBOs, indirectly through securities intermediaries or their agents. Issuers are required to reimburse securities intermediaries for expenses incurred in forwarding communications to beneficial owners. These expenses include reimbursement for postage, envelopes and communication expenses as well as fees to proxy service providers.[156]
- Some issuers have claimed that the expense of obtaining the list of NOBOs from the securities intermediary or its proxy service provider deters some issuers, particularly widely-held issuers, from using the NOBO list to communicate with beneficial owners.[157] We have also received expressions of concern from broker-dealers about the difficulty of maintaining an accurate NOBO list when a class of securities is actively traded.
- We also have heard that issuers may desire more flexibility to design the proxy materials (e.g., forms of VIFs, packaging of materials, etc.) that are sent to beneficial owners. Some issuers believe that the current uniform appearance of proxy materials used by some of the proxy service providers may lead to reduced interest in the materials by beneficial owners. Other commentators have

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156 See Section III.D, above. See also Supplementary Material to NYSE Rules 451 and 465; NYSE Listed Issuer Manual § 402.10(A).

157 Under current NYSE rules, the issuer is required to pay $0.065 per NOBO name, plus reasonable expenses of the broker-dealer's agent in providing the information. NYSE Rule 465 Supplementary Material, available at http://nyserules.nyse.com/NYSETools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F5%5F13%5F1&CiRestriction=465&manual=%2Fnyse%2Frules%2Fnyse%2Drules%2F; FINRA Rule 2251 Supplementary Material.

suggested that VIFs do not sufficiently inform shareholders as to how their shares will be voted if they do not provide instructions on all the matters included on the VIFs.[158]

- Some issuers also have expressed concerns regarding potential quality control problems that have arisen, from time to time, with the services provided by proxy service providers. Similarly, retail investors have complained to our Office of Investor Education and Advocacy, from time to time, that proxy materials have been delivered late. To the extent that delivery of proxy materials is delayed, the utility of issuer-investor communication through the proxy process is impaired.

2. Potential Regulatory Responses

Many issuers, securities intermediaries and commentators believe that there can be more efficient and cost-effective ways for issuers to communicate directly with their shareholders. Some commentators have advocated for significant changes. The 2004 Business Roundtable rulemaking petition ("BRT Petition")[159] recommended that the Commission enable issuers to communicate directly with their beneficial owners by requiring broker-dealers and banks to execute an omnibus proxy in favor of their underlying beneficial owners and by eliminating the ability of beneficial owners to object to the disclosure of their identities to issuers. The BRT Petition argued that eliminating objecting beneficial owner status would create a more efficient proxy system by allowing issuers to bypass securities intermediaries and their agents in forwarding proxy materials and by simplifying the voting and tabulation process.

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158 See James McRitchie, Request for rulemaking to amend Rule 14a-4(b)(1) under the Securities Exchange Act of 1934 to prohibit conferring discretionary authority to issuers with respect to non-votes on the voter information form or proxy. No. 4-583 (May 15, 2009).

159 See BRT Petition, note 8, above.

In 2009, the Shareholder Communications Coalition[160] filed a letter supporting the BRT Petition and providing more specific recommendations on how to implement a system that eliminates objecting beneficial owner status and grants the right to vote directly to the beneficial owners through an omnibus proxy.[161] This proposed system would separate the functions of beneficial owner data aggregation and proxy communications distribution, thereby making beneficial owner data available to the issuer's (and not the securities intermediary's) agent. The system would identify all beneficial owners except those that elect to remain anonymous by registering shares in a nominee account.[162]

Others advocate less comprehensive change and encourage adoption of an approach in which an issuer would be entitled to a list of all beneficial owners, but only as of the record date for a particular meeting.[163] In such a system (an "annual NOBO" system), objecting beneficial owners would not be able to shield their identity for purposes of a shareholder meeting. At any other time during the year, objecting beneficial owner information would not be available to the issuer or any other party. An annual NOBO system would enable issuers to communicate directly with all of their shareholders, both registered and beneficial owners, for purposes of a shareholder

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160 The Shareholder Communications Coalition is an umbrella group that represents the views of The Business Roundtable, the Society of Corporate Secretaries and Governance Professionals, the National Investor Relations Institute, and the Securities Transfer Association.

161 See SCC Discussion Draft, note 139, above.

162 A beneficial owner could continue to remain anonymous by hiring a third party to hold the securities for the beneficial owner. In this circumstance, however, the cost of this agency arrangement would be borne by the beneficial owner.

163 The Altman Group, "Practical Solutions to Improve the Proxy Voting System" (Oct. 2009), available at http://altmangroup.com/pdf/PracticalSolutionTAG.pdf (identifying this approach as the "ABO" or "all beneficial owners"system). We use the term "annual NOBO" because we believe it better reflects the fact that, under the system, an OBO would be treated as if it were a NOBO, but only annually or for specific proxy solicitations.

meeting, while minimizing the possibility that the investor information will be used for purposes other than proxy solicitation, such as determining an investor's trading strategies.

Others have suggested more gradual change.[164] In order to encourage holding in NOBO rather than OBO status, some have suggested various steps to promote selection of NOBO status, such as educating investors about OBO and NOBO status when they open their accounts or periodically. Other steps may involve the elections made by investors when they open their accounts. While our rules contemplate that investors must object to disclosure of their identities to issuers,[165] neither our rules nor self-regulatory organization ("SRO") rules currently require disclosure of the consequences of choosing OBO or NOBO status, or specify broker-dealer policies or procedures with regard to their clients' choice of OBO or NOBO status. In particular, if a securities intermediary's standard customer agreement includes a default election of OBO status, it could promote a less than fully considered election of OBO status. While several broker-dealers have informed us that they currently default beneficial owners to NOBO status, it has been recommended that the default agreement used by all broker-dealers be NOBO status, or that broker-dealers provide informational materials to their customers prior to allowing the customers to elect OBO status and contact customers who elect OBO status periodically to re-elect their OBO/NOBO status.

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164 See, e.g., CII OBO/NOBO Report, note 141, above.

165 See Exchange Act Rule 14b-1(b)(3)(i) [17 CFR 240.14b-1(b)(3)(i)] (requiring broker-dealers to provide names, addresses, and securities positions of customers who have not objected to disclosure of such information); Exchange Act Rule 14b-2(b)(4) [17 CFR 240.14b-1(b)(3)(i)] (requiring banks to provide names, addresses, and securities positions of customers that have not objected to disclosure of such information for customer accounts established after December 28, 1986, but requiring affirmative consent to disclosure of such information for customer accounts opened before that date).

In addition, there remains the issue of whether beneficial owners have a privacy right with respect to the disclosure of their ownership positions. We have been informed of a variety of privacy considerations: some investors, particularly institutional investors, select OBO status for competitive reasons, in order to mask their investment strategies; other investors may prefer OBO status in order to minimize the communications (particularly telephone calls) they receive regarding their investments.[166] In either case, however, according to a study by the NYSE, investor preference for OBO status may be cost-sensitive and perhaps even overstated.[167]

3. Request for Comment

As discussed above, we are considering whether regulatory action is needed to make it easier for issuers to communicate with their investors. In particular, we seek comment on whether we should eliminate the OBO/NOBO distinction, thereby making all beneficial owner information available to the issuer, or require broker-dealers to disclose the consequences of choosing OBO or NOBO status, or whether OBO or NOBO status should be the default choice. We also are exploring ways in which issuers can communicate directly with beneficial owners, such as requiring securities intermediaries to transfer proxy voting authority to some or all beneficial owners, so that issuers can solicit proxies directly from such holders. In this regard, we seek comment on the following questions:

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166 See SIFMA Report, note 134, above, at 10, 12, 20-22.

167 Investor Attitudes Study Conducted for NYSE Group – April 7, 2006, available at http://www.nyse.com/pdfs/Final_ORC_Survey.pdf. In that study, 71% of respondents indicated that they would provide contact information to the issuers in which they invest if asked. In addition, the study notes that investor preference for NOBO status increases if fees are imposed on continuing to maintain OBO status: with the imposition of a $50 annual fee, preference for OBO status declines from 36% to 5%. Id. at 3.

- Do our existing rules inappropriately inhibit issuers from effectively communicating with investors? If so, what changes should we make to our rules to improve investor communication? Even if our rules do not inappropriately inhibit issuers from effectively communicating with investors, do the rules significantly raise the cost of communicating? Do any non-Commission rules inappropriately inhibit issuers from effectively communicating with investors? What are the benefits and costs of the various changes proposed by commentators?
- Do investors consider the degree and manner of communication with issuers to be adequate?
- To what extent are proxy materials not being delivered in a timely fashion? Are any changes in our rules or other rules required to improve timeliness of delivery, either with respect to registered or beneficial owners?
- What impact does the uniform appearance of proxy materials such as the VIF have on shareholder participation in proxy voting? Would investors, especially retail investors, be more likely to vote if there was less uniformity in the appearance of proxy materials?
- Is the format and layout of proxy cards and VIFs clear and easy to use from the perspective of investors? Could the layout be improved to enhance investor participation? Do the formats of proxy cards and VIFs appropriately set out the consequences of not voting or giving voting instructions on one or more specific matters?

- To what extent has the loss of broker discretionary votes in uncontested elections of directors increased the likelihood that issuers will not meet quorum requirements? Would the availability of less-costly means of communication with shareholders improve issuers' ability to meet quorum requirements?
- Do investors have legitimate privacy interests with respect to the disclosure of their share ownership? In what ways would an investor be harmed if his or her identity and the size of his or her holdings are disclosed to issuers? Should an investor be able to indicate that he or she does not wish to be contacted by an issuer? Do broker-dealers or banks have legitimate commercial interests in keeping the identities of their customers confidential? How should these interests be balanced against an issuer's interest in identifying and communicating with its investors? Is this balance different for individual and institutional investors, and if so, would different treatment in regard to OBO status be appropriate? Are there technological solutions that would facilitate communication while protecting the identities of shareholders?
- Issuers have expressed interest in not only communicating with shareholders, but also in identifying them. While these interests can be complementary, is one more important than the other? Should any regulatory changes that may be considered by the Commission emphasize one over the other?

- Are there merits to, or concerns about, establishing a central beneficial owner data aggregator for use by issuers, as suggested by the Shareholder Communications Coalition and as described above?
- Is competition in the proxy distribution service market needed, and if so, what changes to facilitate issuers' communications with investors would also encourage competition in the proxy distribution service market?
- Should we consider rules that would shift the cost of distributing proxy materials to broker-dealers for customers who choose to be objecting beneficial owners?
- Do our rules adequately address how beneficial owners elect objecting or non-objecting beneficial owner status when they open their accounts? Should there be a requirement that beneficial owners' account agreements adopt any specific election as the default choice? If so, would it matter whether the Commission, FINRA, or the stock exchanges imposed that requirement? Should the required default choice be for objecting or non-objecting beneficial owner status? Are there other ways in which default positions can be established for customers of securities intermediaries? Should there be a standardized form for customers to elect either NOBO or OBO status?
- Should we or SROs instead, or in addition, consider requiring securities intermediaries to provide informational materials to their customers prior to allowing the customer to elect OBO or NOBO status? What should be included in such informational materials, and how frequently should

investors be provided with such materials? Should we consider requiring securities intermediaries to inform customers of the reasons for and against choosing to disclose or shield their identities?

- Should a broker-dealer periodically request that customers reaffirm their OBO/NOBO status selection? If so, how should the cost of this periodic evaluation be allocated?
- Should we consider revising our rules to require that securities intermediaries provide an omnibus proxy to their underlying beneficial owners and identify them to the issuer? If we were to propose such a rule, should we limit it to granting proxies to NOBOs since their identities are already available to issuers? How would such a system address the way securities transactions are cleared and settled?
- What are the costs and benefits of the annual NOBO system suggested by commentators? Would disclosure of all beneficial owners, limited to information as of the record date of a shareholder meeting, harm those investors (for example, would it reveal trading strategies of those investors)? Would implementing the annual NOBO system adversely affect any privacy interests of OBOs? As a practical matter, would issuers be able to contact OBOs using this information for subsequent shareholder meetings?
- What problems might arise if issuers or their transfer agents have greater access to or control of shareholder lists? How could we provide for fair and efficient access to those lists by other soliciting parties?

B. Means to Facilitate Retail Investor Participation

1. Background

As we seek to promote and facilitate shareholder voting in general, we understand that the level of voting by retail investors is a particular area of concern. Retail investor participation rates in the proxy voting process historically have been low.[168] Given the importance of proxy voting, we view significant lack of participation by retail investors in proxy voting as a source of concern, even in companies in which retail share ownership represents a relatively small portion of total voting power. We understand that this situation is not limited to the U.S., as the level of voting by shareholders in other jurisdictions has also caused concern.[169]

2. Potential Regulatory Responses

a. Investor Education

Commentators have indicated that there is confusion among investors regarding the proxy voting process and the importance of voting.[170] Investors accustomed to brokers voting their shares on their behalf may be unaware that, as a result of the recent revisions to NYSE Rule 452, brokers can no longer vote investors' shares in uncontested elections of corporate directors without instructions from the investors. In addition, many investors may be confused by the distinction between record and beneficial ownership and how that may affect their voting rights. These commentators have recommended the development of a significant investor education campaign to inform investors about the

168 See Roundtable Briefing Paper, note 79, above.

169 See, e.g., Myners Report, note 15, above.

170 See Proxy Working Group Report, note 107, above, at 15.

proxy voting process and the importance of voting as one way in which communication and proxy voting could be improved.

We believe that improved investor education may help dispel some of these potential misunderstandings and create interest in the voting process. There are several ways in which we can enhance the educational opportunities for investors. We recently created a new section on our investor site, www.investor.gov, to provide educational materials about proxy mechanics generally and the notice and access model for the delivery of proxy materials. The new proxy matters section can be found at www.investor.gov/proxy-matters.[171] We understand that a number of issuers and shareholder organizations have provided links from their Web sites to these educational materials. In addition, NYSE recently revised examples of letters containing the information and instructions required to be given by NYSE members to beneficial owners to inform beneficial owners that brokers are no longer allowed to vote shares held by beneficial owners on uncontested elections of directors, unless the beneficial owner has provided voting instructions.[172]

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171 The staff of the Commission initiated an educational program on proxy voting matters for retail investors with the goal of increasing investor awareness about the importance of participating in director elections and other issues brought before shareholders at annual and special meetings. A plain-language "Spotlight on Proxy Matters page" in question and answer format was developed on the SEC Web site to explain proxy voting procedures. In addition, the staff of our Office of Investor Education and Advocacy has spoken before investor and issuer organizations to promote the Web site material and to urge their involvement in proxy voting educational programming. To date, this ongoing effort has yielded more than 25,000 unique visits to the Proxy Matters website and 1,430 references on Google. The staff plans to continue and expand the education and outreach to retail investors in preparation for the 2011 proxy season. As part of this outreach program, we are exploring potential opportunities to link proxy educational materials directly to online brokerage accounts and other locations that may be visited frequently by retail shareholders.

172 See Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Modify the Sample Broker Letters Set Forth In Rule 451, Release No. 34-61046 (Nov. 20, 2009) [74 FR 62849].

Another possible venue for investor education is issuers' Web sites and brokers' Web sites. Many investors go to issuer Web sites to obtain information about the issuers in which they invest, and an increasing number of investors review their holdings and effect securities transactions through their brokers' Web sites. More proxy-related educational materials located on an issuer's or broker's Web site may be helpful to investors. In addition, although some explanation of how the proxy process works is often included on the back of the proxy card (or on the VIF), that information can be difficult to read and is often presented in small print. We are interested in whether improving the presentation of information on the proxy card or VIF would have an effect on voting participation.

Finally, we are interested in whether we should also consider the scope, format, and content of the communications between brokers and their customers that occur in connection with opening customers' accounts. The account-opening process may be a good opportunity to communicate important information about the shareholder voting process.

b. Enhanced Brokers' Internet Platforms

As noted above, many investors use their brokers' Web sites as "one-stop shopping" for their investment needs. It is our understanding, however, that many of these Web sites do not provide information about upcoming corporate actions or enable retail investors to use the same platform for proxy voting. Rather, many brokers hire a third-party proxy service provider to handle the collection of voting instructions. Therefore, those investors must go to a different Web site, not run by the broker, in order to submit voting instructions to their broker. We are interested in receiving views on whether receiving notices of upcoming corporate votes and having the ability to access proxy materials and a VIF through the investor's account page on the broker's Web site would be helpful to investors. We also wish to explore whether other communications from broker to customer could encourage more active and better informed participation in the proxy voting process.

c. Advance Voting Instructions

Some commentators have recommended that we adopt rules to facilitate what has been called "client-directed voting" as a means to increase investor participation in the voting process.[173] In general, this concept contemplates that brokers or other parties[174] would solicit voting instructions from retail investors on particular topics (e.g., election of directors, ratification of auditors, approval of equity compensation plans, action on shareholder proposals) in advance of their receiving the proxy materials from companies.[175] The advance voting instructions would then be applied to proxy cards or VIFs related to the investors' securities holdings, unless the investors changed those instructions. Investors would be able (but not required) to instruct their securities intermediaries or other parties to vote their shares in any number of ways, including the following:

- Vote shares in accordance with the board of directors' recommendations;
- Vote shares against the board of directors' recommendations;

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173 See Proxy Working Group Addendum, note 127, above. We use the term "advance voting instructions" rather than "client-directed voting" because we believe it more precisely identifies the salient feature of this approach to shareholder voting.

174 Such parties could include proxy advisory firms or other third parties offering voting platforms to facilitate voting by retail investors.

175 As noted above, proxy advisory services sometimes submit votes on behalf of their institutional investor clients pursuant to the clients' proxy voting policies.

- Vote shares related to particular types of proposals (for example, shareholder proposals related to environmental or social issues) consistent with recommendations issued by specified interest groups, proxy advisory firms, investors, or voting policies;
- Abstain from voting shares; or
- Vote shares proportionally with the brokerage firm's customers' instructed votes, or the instructed votes of its institutional or retail customers only.[176]

The advance voting instructions would generally be given by the investors at the time they sign their brokerage agreements or sign up for the proxy voting service, or periodically thereafter, and would always be revocable. Investors would also be able to change the advance voting instructions at any time.

In connection with each proxy solicitation, investors who had given advance voting instructions would receive a proxy card or VIF pre-marked in accordance with those voting instructions, along with the proxy materials required by the federal securities laws. Investors could override any of the advanced voting instructions applicable to that proxy solicitation by checking or clicking on an appropriate election box before the vote is submitted. Absent instructions to the contrary, the securities intermediary or other party would vote the investor's shares in accordance with the advance voting instructions as pre-marked on the proxy card or VIF.

In connection with the proposal to amend NYSE Rule 452,[177] we received several comment letters that discussed advance voting instructions as an alternative to the NYSE

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[176] See Proxy Working Group Addendum, note 127, above; see also John Wilcox, Fixing the Problems with Client-Directed Voting, March 5, 2010, available at http://blogs.law.harvard.edu/corpgov/2010/03/05/fixing-the-problems-with-client-directed-voting/.

Rule 452 amendment[178] or advocated that such voting instructions should be considered in conjunction with the NYSE Rule 452 amendment.[179] In the order approving the NYSE Rule 452 amendment, we noted that advance voting instructions raise a variety of questions and concerns, such as requiring investors to make a voting decision in advance of receiving a proxy statement containing the disclosures mandated under the federal securities laws and possibly without consideration of the specific issues to be voted upon.[180] The Proxy Working Group also expressed concern that advance voting instructions could act as a disincentive for retail investors to vote after reviewing proxy materials if they had already given such instructions.[181] On the other hand, supporters of advance voting instructions stated that the implementation of voting based on such instructions could help issuers solve quorum problems, encourage greater retail shareholder participation in the voting process by making it easier for investors to vote,

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177 On July 1, 2009, the Commission approved an amendment to NYSE Rule 452 and Section 402.08 of the NYSE Listed Issuer Manual that eliminated discretionary voting by brokers in uncontested director elections. See Release No. 34-60215, note 11, above.

178 See comment letters from American Bar Association ("ABA Letter"); American Business Conference; Agilent Technologies, Inc.; Business Roundtable; United States Chamber of Commerce; Connecticut Water; DTE Energy; First Financial Holdings, Inc.; Furniture Brands International; General Electric; Intel Corporation; Jacksonville Bancorp Inc.; McKesson Corporation; Monster Worldwide, Inc.; Nucor Corporation; Provident Bank; Provident Financial Services, Inc.; Quest Diagnostics Inc.; Synalloy Corporation; and Veeco Instruments Inc to Notice of Filing of Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors and Codify Two Previously Published Interpretations That Do Not Permit Broker Discretionary Votes for Material Amendments to Investment Advisory Contracts, Release No. 34-59464 (Feb. 26, 2009), available at http://www.sec.gov/comments/sr-nyse-2006-92/nyse200692.shtml.

179 See comment letters from American Express; Society of Corporate Secretaries and Governance Professionals ("Governance Professionals Letter"); Honeywell; JPMorgan Chase & Co.; and Shareholder Communications Coalition to Release No. 34-59464, note 178, above, available at http://www.sec.gov/comments/sr-nyse-2006-92/nyse200692.shtml.

180 See Release No. 34-60215, note 11, above, at 34.

181 See Proxy Working Group Addendum, note 127, above, at 5.

better permit shareholders to exercise their franchise, and result in more discussion and involvement between investors and their brokers on proxy issues.[182]

While we will continue to consider the advisability of allowing third parties, such as broker-dealers, to solicit instructions regarding the voting of shares by retail investors without the benefit of information that is contained in disclosures that our rules require in connection with shareholder votes, we recognize that facilitating the use of advance voting instructions can be viewed as providing retail investors with a component of the services now made available to institutional investors by proxy advisory firms. However, retail investors are not necessarily in the same position as institutional investors. Some institutional investors rely upon pre-developed voting policies and procedures to ensure consistency across portfolios, to aid in post-vote monitoring and reporting, and otherwise to comply with applicable fiduciary duties. Some retail shareholders may not be as likely to monitor, or hire others to monitor, the application of their advance voting instructions.

There is currently no applicable exemption for securities intermediaries to solicit advance voting instructions from their customers. Exchange Act Rule 14a-2(a)(1) provides an exemption from the proxy solicitation rules to securities intermediaries when they forward proxy materials on behalf of issuers and request voting instructions.[183] This exemption, however, requires securities intermediaries to "promptly furnish" proxy materials to the person solicited. By definition, brokers seeking to obtain advance voting instructions from customers would not be able to satisfy this requirement. In the absence of an applicable exemption for the solicitation of advance voting instructions, Rule

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182 Id. at 5-6. See also Governance Professionals Letter, note 179, above; ABA Letter, note 177, above; and Frank G. Zarb, Jr. and John Endean, "The Case for 'Client Directed Voting,'" Law 360 (Jan. 4, 2010).

183 17 CFR 240.14a-2(a)(1).

14a-4(d) states that no proxy shall confer authority to vote at any annual meeting other than the next annual meeting after the date on which the form of proxy is first sent.[184] In addition, that rule prohibits a proxy from granting authority to vote with respect to more than one meeting.[185]

To pursue this alternative further, there are a number of issues that would need to be considered. Advance voting instructions could be solicited to varying levels of detail. For instance, such an instruction could be very broad, such as "vote consistent with management's recommendations" or "vote consistent with the recommendations of XYZ Environmental Group." The grant of such broad authority could raise concerns about the extent to which the investor's vote is an informed one. Greater specificity in a request for instructions, however, could provide an investor with greater certainty regarding what his or her instruction relates to. For example, an instruction to "vote consistent with [management's or other party's] recommendations regarding corporate governance issues" would provide more certainty.

In addition, if we were to permit advance voting instructions, we would need to address other issues including whether such instructions should be re-affirmed on a periodic basis; whether they should apply to the voting of shares of issuers that the investor did not own when the original instructions were submitted; whether they should be re-affirmed each time an investor purchases additional shares of an issuer's stock for which that investor has already submitted voting instructions; and whether brokers can seek from investors advance voting instructions that vary by company.

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184 17 CFR 240.14a-4(d)(2).

185 17 CFR 240.14a-4(d)(3).

We are interested in receiving views on whether permitting advance voting instructions would increase retail investor participation in the voting process, and on whether such instructions would be appropriate as a general matter. If such instructions would increase retail investor participation and would be appropriate, we are interested in receiving views on any conditions or requirements that we should consider applying to the solicitation of such instructions.

d. Investor-to-Investor Communications

We are interested in receiving views on whether investor interest in matters presented to shareholders is affected by the extent to which investors are able to communicate with other investors about their opinions regarding matters up for a vote. It is our understanding that there tends to be higher voting participation in situations that involve increased communications and high investor interest, such as well-publicized proxy contests. We have, in the past, adopted several provisions designed to enhance shareholder communications between investors and the issuer, as well as among investors, including:

- Exempting communications with investors from the proxy statement delivery and disclosure requirements where the soliciting person is not seeking proxy authority and does not have, among other things, a substantial interest in the matter (other than as an investor in the issuer);[186]

[186] 17 CFR 240.14a-2(b)(1). The rule specifies certain individuals and entities, such as affiliates of the registrant, that are not entitled to rely on the exemption. Also, if the shareholder owns more than $5 million of the registrant's securities, it must furnish a Notice of Exempt Solicitation to the Commission. 17 CFR 240.14a-6(g).

- Permitting an investor to publicly announce how it intends to vote and provide the reasons for that decision without having to comply with the proxy rules;[187] and
- Broadening the types of communications that are permissible prior to the distribution of a definitive proxy statement.[188]

In addition, in 2007, we adopted rules promoting the use of electronic shareholder forums on the Internet for investor communications.[189] It is our understanding that such forums have not been used extensively. We are interested in receiving views on whether, if further steps are taken to facilitate informed discussion among investors, the level of investor voting participation and informed proxy voting would be likely to increase. In addition, we are interested in receiving views on whether any additional forums for shareholder-to-shareholder communications would be helpful.

e. Improving the Use of the Internet for Distribution of Proxy Materials

In 2007, we amended the proxy rules to adopt a "notice and access model."[190] This model provides issuers with two options for making their proxy materials available: the "notice-only option"[191] and the "full set delivery option." Under the notice-only

[187] 17 CFR 240.14a-1(l)(2)(iv).

[188] 17 CFR 240.14a-12; Regulation of Takeovers and Security Holder Communications, Release No. 33-7760 (Oct. 22, 1999) [64 FR 61408].

[189] See Release No. 34-57172, note 3, above.

[190] See Notice and Access Release, note 2, above.

[191] The notice and access model is a concept separate from, but complementary to, electronic delivery. The notice and access model permits an issuer (or a securities intermediary at the direction of the issuer) to deliver a notice (typically in paper) informing shareholders that proxy materials are available on the Internet in lieu of sending a full paper set of proxy materials. Electronic delivery, on the other hand, arises from our guidance in Release No. 33-7233, note 32, above. In that release, we explained that delivery of materials (including proxy materials) may be made electronically under certain circumstances, including if a shareholder has provided affirmative consent to electronic delivery. An issuer or securities intermediary may send this

option, the issuer must post its proxy materials on a publicly-accessible Web site and send a notice to shareholders at least 40 days before the shareholder meeting date to inform them of the electronic availability of the proxy materials, and explain how to access those materials.[192] Under this option, an issuer must also provide paper or e-mail copies of proxy materials at no charge to shareholders who request such copies.[193]

Issuers may also select the "full set delivery" option, where the issuer delivers a full set of proxy materials to shareholders, along with the Notice of Internet Availability of Proxy Materials on a Web site, and posts the proxy materials to a publicly-accessible Web site.[194] An issuer may use the notice-only option to provide proxy materials to some shareholders, and the full set delivery option to provide proxy materials to other shareholders.[195]

It has been suggested that our adoption of rules permitting the dissemination of proxy materials through a "notice and access" model has contributed to a decline in retail investor participation in voting. We believe that it is difficult to conclude, based on existing data, that notice and access has caused changes in voter participation. To be sure, the number of retail accounts submitting voting instructions when issuers use the notice-only option is lower than the number of retail accounts submitting voting instructions when issuers use the full-set delivery option. The number of retail shares

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notice electronically to a shareholder if that shareholder has affirmatively consented to electronic delivery.

192 See 17 CFR 240.14a-16; Notice and Access Release, note 2, above.

193 17 CFR 240.14a-16.

194 Id. The issuer may elect to include all of the information required to appear in the Notice in the proxy statement and proxy card. Id.

195 Id.

being voted, however, does not appear to differ substantially.[196] More importantly, because issuers can elect whether to use the notice-only model, it is difficult to discern whether patterns in voting behavior are due to notice and access or to other factors. Issuers who choose the notice-only model may differ from other issuers in ways that may also correlate with voter participation, such as size or other characteristics. Some issuers have chosen a hybrid model, continuing to distribute full packages of proxy solicitation materials to selected shareholders based on the size of their holdings or their voting histories,[197] suggesting that these issuers may believe that full-set delivery affects voter participation in some cases.

Another possible option to encourage shareholder participation, while still allowing issuers to use the notice-only option, would be to permit the inclusion of a proxy card or VIF with the Notice of Internet Availability of Proxy Materials when an issuer or other soliciting shareholder elects to use the notice-only option under the notice and access model for the delivery of proxy materials. Currently, Exchange Act Rule 14a-16 explicitly prohibits the soliciting party from including a proxy card or VIF with the Notice in the same mailing.[198] Although we initially proposed a model that would have allowed soliciting parties to include a proxy card or VIF with the Notice, we ultimately adopted a rule that prohibited the inclusion of the proxy card or VIF and noted

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196 See Broadridge, Notice and Access: 2010 Statistical Overview of Use with Beneficial Shareholders, available at http://www.broadridge.com/notice-and-access/FY10_full_year.pdf ("2010 Broadridge Statistical Overview"). This report indicates that, during the 2009 and 2010 proxy seasons, 31.95% and 27.29%, respectively, of retail shares were voted at issuers not using notice and access, while 28.70% and 31.01%, respectively of retail shares were voted at issuers using notice and access. On the other hand, 19.39% and 19.21%, respectively, of retail accounts were voted at issuers not using notice and access, while 12.72% and 13.85%, respectively, of retail accounts were voted at issuers using notice and access.

197 Id.

198 17 CFR 240.14a-16(e). A proxy card or VIF may be included with a Notice if at least 10 days have passed since the date a Notice was first sent to shareholders. 17 CFR 240.14a-16(h)(1).

commentators' concerns that "physically separating the card from the proxy statement, as originally proposed, may lead to the type of uninformed voting that the proxy rules are intended to prevent." [199]

3. Request for Comment

With respect to investor education, we ask the following questions:

- To what extent should we take additional steps to encourage retail investor participation in the proxy process?
- To what extent would greater use of plain English, some form of summary of proxy materials, or layered formats in Web-based disclosure make proxy materials more accessible to retail investors?
- To what extent are retail voter participation levels affected by process-related impediments to participation? If affected by impediments, what are they and should we seek to remove them? What costs and benefits are associated with efforts to increase participation?
- Would additional investor education improve retail investor participation in the proxy process? How could such a program best reach both registered owners and beneficial owners? What would be the benefits and costs of such a program? What should be in the educational materials and who should decide what goes in them?
- Should brokers more clearly highlight and disclose key policies, including a shareholder's voting rights and default positions, such as OBO/NOBO, when a customer enters into a brokerage agreement? Should brokers

[199] Internet Availability of Proxy Materials, Release No. 34-55146 (Jan. 22, 2007) [72 FR 4148] at 4153.

provide counseling to potential customers to enhance understanding of such provisions in the brokerage agreement? When a customer enters into a brokerage agreement, should brokers be required to obtain the preferences of the client regarding whether to receive proxy materials electronically, and inform issuers of that election automatically when securities of that issuer are purchased?

- What role should the Commission play in promoting or developing the education campaign? How can the SEC's investor education Web sites be made more useful? For example, should the Web site provide interactive instruction?

With respect to enhanced issuers' and brokers' Internet platforms, we ask the following questions:

- Would an issuer's Web site or a broker's Web site be a useful location for investor educational information? Are there other methods to effectively educate investors? What would be the costs and benefits of requiring issuers or securities intermediaries to include such information on their Web sites?
- Should issuers or brokers enhance their Web sites, if they have one, to provide the issuers' shareholders or the brokers' customers, respectively, with the ability to receive notices of upcoming corporate votes, to access proxy materials and to vote shares through their personal account pages? What would be the costs of such a system? Would adding this service for

investors make them more likely to vote? To what extent do issuers and brokers currently provide such functionality on their Web sites?

- Should we encourage the creation of inexpensive or free proxy voting platforms that would provide retail investors with access to proxy research, vote recommendations, and vote execution? If so, how?

With respect to advance voting instructions, we ask the following questions:

- Should we consider allowing securities intermediaries to solicit voting instructions in advance of distribution of proxy materials pursuant to an exemption from the proxy solicitation rules? Should there be any conditions on any such exemption, and if so, what should they be?
- To what extent would voting instructions made without the benefit of proxy materials result in less informed voting decisions? Are there countervailing benefits to permitting the solicitation of such instructions? To what extent does the revocability of advance voting instructions mitigate concerns over less informed voting decisions?
- With regard to the use of advance voting instructions, are retail investors at a disadvantage as compared to institutional investors that use the services of a proxy advisory firm? If so, how? Are there aspects of the services and relationship between proxy advisory firms and their clients that would not exist between securities intermediaries soliciting advance voting instructions and their customers? If so, how should these differences be addressed, if at all?

- If such solicitation of advance voting instructions were permitted, what level of specificity should the solicitation of advanced voting instructions be required (or permitted) to have? Is it appropriate to permit the solicitation of a broad scope of voting authority?
- Should we allow the solicitation by securities intermediaries of advance voting instructions for all types of proxy proposals, or should it be limited to certain types of proposals? For example, should we permit solicitation of advance voting instructions with respect to shareholder proposals, proxy contests, or proposals subject to "vote no" campaigns?
- If solicitation of advance voting instructions were permitted, should the investor be permitted to instruct the securities intermediary to vote in accordance with the recommendations of management, a proxy advisory firm, or other specified persons? How neutral or balanced should the solicitation of advance voting instructions be?
- If we were to allow the solicitation of advance voting instructions, should we require an investor to reaffirm its voting instructions periodically? If so, how often? Should we require an investor to reaffirm its voting instructions every time it purchases additional shares of a stock for which that investor has already submitted a voting instruction, or when it purchases shares of a new issuer?
- If we were to allow advance voting instructions, what would be an appropriate range of options available to an investor? Should advance

voting instructions only be permitted when the investor has meaningful options from which to choose?

- How difficult would it be to obtain advance voting instructions from existing brokerage customers? What would be the costs of obtaining advance voting instructions for existing accounts? Who should bear the costs of soliciting such instructions?
- If we were to allow the solicitation of advance voting instructions, would it undermine or promote the purpose of the recent amendment to NYSE Rule 452 to prohibit brokers from voting uninstructed shares in uncontested elections of directors?

With respect to investor-to-investor communications, we ask the following questions:

- To what extent are investor interest in matters presented to shareholders and investor voting participation affected by the lack of investor-to-investor communications regarding those matters?
- Have electronic shareholder forums been used extensively? Are there any revisions to Rule 14a-2(b)(6), which currently provides an exemption for electronic shareholder forums, that would make it easier to establish such forums? For example, is there a way for an entity establishing an electronic shareholder forum to confirm the shareholder status of participants on the forum? If a securities intermediary provides information, such as a control number, to enable such confirmation, should precautions be taken to ensure that personal information about those investors is not disclosed?

- Should we consider revising the electronic shareholder forum rules to shorten the 60-day period to promote more shareholder-to-shareholder communication closer to the meeting date? If so, what would be an appropriate time period?
- Are there any other new rules or revisions to existing rules that would facilitate communications among investors? If so, what would those revisions be?
- Would any additional guidance regarding the scope of our rules and definitions, such as the definition of the term "solicitation," improve the extent and quality of investor participation in the proxy voting process?

With respect to possible revisions to the notice and access model, we ask the following questions:

- Should we consider requiring that companies using a "notice and access" model for distributing proxy materials use that model on a stratified basis to encourage retail voting participation? For example, should we require that issuers send full sets of proxy materials to shareholders who have voted on paper in the past two years?
- Should we consider amending our rules to permit inclusion of a proxy card or VIF with a Notice of Internet Availability of Proxy Materials?
- Are there other changes that we can make to the notice and access model to improve voting participation? For example, should we require affirmative consent from a shareholder before an issuer is allowed to send

that customer only a Notice of Internet Availability of Proxy Materials? Should we eliminate the notice and access model altogether?

C. Data-Tagging Proxy-Related Materials

1. Background

Issuers soliciting proxies are required to distribute a proxy statement[200] and to disclose the results of shareholder votes within four business days after the end of the meeting at which the vote was held.[201] Funds are generally required to disclose annually on Form N--PX[202] how they vote proxies relating to portfolio securities.[203] In the discussion below, we address whether this information could be organized and made available to investors in ways that might enhance the level and quality of shareholder participation in the proxy voting process.

In 2004, as part of our longstanding efforts to increase transparency in general and the usefulness of information in particular, we began an initiative to assess the benefits of interactive data[204] and its potential for improving the timeliness, accuracy, and analysis of financial and other filed information.[205] Data becomes interactive when it is labeled, or

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200 The proxy statement must include the information required by Schedule 14A of the Exchange Act. [17 CFR 240.14a-101] The Commission's rules also generally require issuers not soliciting proxies from shareholders entitled to vote on a matter to distribute an information statement that must include the similar information required by Schedule 14C of the Exchange Act [17 CFR 240.14c-101]. Accordingly, the data-tagging discussion in this Section IV.C relates to the information required by Schedule 14C in the same manner it relates to corresponding information required by Schedule 14A.

201 Item 5.07 of Form 8-K [referenced in 17 CFR 249.308].

202 17 CFR 274.129. See Section III.C, above, for a further discussion of Form N-PX.

203 In this Section IV.C, we use the term "proxy statement and voting information" to refer collectively to the information required by Schedule 14A, Schedule 14C, Item 5.07 of Form 8-K and Form N-PX.

204 In this Section IV.C, we generally refer to "tagged data" as "interactive data" because users are able to interact with the data by processing it.

205 See Press Release No. 2004-97 (July 22, 2004), available at http://www.sec.gov/news/press/2004-97.htm.

"tagged," using a computer markup language that can be processed by software for analysis. Such computer markup languages use standard sets of definitions, or "taxonomies," that translate text-based information in Commission filings into interactive data that can be retrieved, searched, and analyzed through automated means.

Our efforts regarding interactive data thus far have resulted in our adoption of rules that, in general, currently or ultimately will require:

- Public issuers, including foreign private issuers, to provide their financial statements to the Commission and on their corporate Web sites, if any, in interactive data format using eXtensible Business Reporting Language ("XBRL");[206]
- Mutual funds[207] to provide the risk/return summary section of their prospectuses to the Commission and on their Web sites, if any, in XBRL format;[208]

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206 Interactive Data to Improve Financial Reporting, Release No. 33-9002 (Jan. 30, 2009) [74 FR 6776] as corrected by Interactive Data to Improve Financial Reporting, Release No. 33-9002A (Apr. 1, 2009) [74 FR 15666]. Issuers that are or will be required to provide their financial statements in interactive data format using XBRL are permitted to provide such interactive data before they are required to do so. Funds are permitted to provide financial information in interactive data format using XBRL as an exhibit to certain filings in our electronic filing system under a voluntary filer program that initially was implemented in 2005.

207 In this Section IV.C, we use the term "mutual fund" to mean an open-end management investment company. An open-end management investment company is an investment company, other than a unit investment trust or face-amount certificate company, which offers for sale or has outstanding any redeemable security of which it is the issuer. See Sections 4 and 5(a)(1) of the Investment Company Act [15 U.S.C. 80a-4 and 80a-5(a)(1)].

208 Interactive Data for Mutual Fund Risk/Return Summary, Release No. 33-9006 (Feb. 11, 2009) [74 FR 7748] as corrected by Interactive Data for Mutual Fund Risk/Return Summary; Correction, Release No. 33-9006A (May 1, 2009) [74 FR 21255]. Mutual funds are permitted to provide their risk/return summary information in interactive data format (using XBRL) before they are required to do so. The public companies, foreign private issuers and mutual funds permitted or required to provide financial statement or risk/return summary information in interactive data format are required to continue to provide the information in traditional format as well.

- Rating agencies to provide certain ratings information on their Web sites in XBRL format; [209]
- Money market funds to provide portfolio holdings information to the Commission in interactive data format using eXtensible Markup Language ("XML"); [210]
- Transfer agents to provide registration, activity and withdrawal information to the Commission in XML format; [211]
- Issuers to provide notice of Regulation D[212] exempt offering information to the Commission in XML format[213] or through the Commission's online forms Web site that tags the information in XML; [214] and
- Officers, directors, and principal owners to provide beneficial ownership information under Section 16(a) of the Exchange Act[215] to the Commission in XML format[216] or through the Commission's online forms Web site that tags the information in XML.[217]

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209 Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-61050 (Nov. 23, 2009) [74 FR 63832] and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-59342 (Feb. 2, 2009) [74 FR 6456].

210 Money Market Fund Reform, Release No. IC-29132 (Feb. 23, 2010) [75 FR 10060]. The XBRL format is compatible with and derives from the XML format.

211 Electronic Filing of Transfer Agent Forms, Release No. 34-54864 (Dec. 4, 2006) [71 FR 74698].

212 17 CFR 230.501 –508.

213 See EDGAR Form D XML Technical Specification (Version 7.4.0), available at http://www.sec.gov/info/edgar/formdxmltechspec.htm.

214 Electronic Filing and Revision of Form D, Release No. 33-8891 (Feb. 6, 2008) [73 FR 10592].

215 15 U.S.C. 78p(a).

216 See EDGAR Ownership XML Technical Specification (Version 3), available at http://www.sec.gov/info/edgar/ownershipxmltechspec.htm.

217 Mandated Electronic Filing and Web Site Posting for Forms 3, 4 and 5, Release No. 33-8230 (May 7, 2003) [68 FR 25788].

Currently, proxy statement and voting information is neither required nor permitted to be provided to the Commission in interactive data format. As a result, shareholders cannot retrieve, search, and use this information through automated means in the form in which it is provided to the Commission.

2. Potential Regulatory Responses

We are interested in receiving views on whether it would be beneficial to investors to permit or require issuers, including funds, to provide proxy statement and voting information in interactive data format in addition to the traditional format. We are also interested in understanding the costs of providing additional tagged information. A significant amount of the textual data in the proxy statement is well-structured and may be suitable for data tagging. If issuers provided reportable items in interactive data format, shareholders may be able to more easily obtain specific information about issuers, compare information across different issuers, and observe how issuer-specific information changes over time as the same issuer continues to file in an interactive data format. This could both facilitate more informed voting and investment decisions and assist in automating regulatory filings and business information processing.[218]

Under our current rules, issuers are permitted or required to provide specified information in interactive data format only as described above. We have, however, previously considered, and sought comment on, permitting or requiring interactive data

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[218] We anticipate that any interactive data format version of the information permitted or required would not replace the traditional format version, at least not initially. In general, interactive data currently is machine-readable only. Without the use of software, interactive data is illegible to the human eye. As a result, we expect that any interactive data would be provided in a separate schedule or exhibit. It is possible, however, that at some point in the future technology will evolve in a manner that would permit human-readable text and interactive data to appear in the same document.

for other types of information in XBRL or another format.[219] Most recently, in the 2008 release proposing the required filing of financial statements in XBRL format,[220] we expanded upon our 2006 request for comment on making executive compensation information available in interactive data format.[221] In the 2008 release, we did not propose permitting or requiring interactive data for executive compensation, but asked a series of questions related to whether we should. As noted in the 2009 release adopting the financial statement XBRL requirements, some commentators supported the idea of eventually tagging non-financial statement information such as executive compensation because of its usefulness to investors,[222] while others expressed concern that variations among issuers in executive compensation practices may not lend themselves to the development of standard tags and suggested that any tagging be voluntary rather than required.[223]

In connection with our efforts to improve communication in the proxy context, we are interested in receiving views on whether we should reconsider whether to permit or

219 With regard to format, we solicited comment in our 2004 interactive data concept release regarding the ability of interactive data to add value to Commission filings, whether in XBRL or another interactive data format. Enhancing Commission Filings Through the Use of Tagged Data, Release No. 33-8497 (Sept. 27, 2004) [69 FR 59111].

220 Interactive Data to Improve Financial Reporting, Release No. 33-8924 (May 30, 2008) [73 FR 32794].

221 Executive Compensation and Related Party Disclosure, Release No. 33-8655 (Jan. 27, 2006) [71 FR 6542]. In 2007, as further discussed below, our staff used XBRL to tag Summary Compensation Table data provided by large filers and created rendering software that enabled investors to not only view compensation information but also manually calculate compensation and compare compensation across companies. The software was called the Executive Compensation Reader. We made these efforts to show how interactive data might provide investors with easier and faster analysis. SEC Press Release 2007-268 (Dec. 21, 2007).

222 See, e.g., comment letter to Release No. 33-9002, note 206, above, from California Public Employees' Retirement System.

223 See, e.g., comment letters to Release 33-9002, note 206, above, from American Bar Association, Johnson & Johnson, Pfizer, General Mills, and Society of Corporate Secretaries and Governance Professionals.

require proxy statement and voting information to be provided in interactive data format.[224]

3. Request for Comment

- Should we permit issuers, including funds, to provide proxy statement and voting information to the Commission and on their corporate Web sites, if any, in an interactive data format? If so, are there benefits to one tagging language (e.g., XBRL) over another?[225] Should we require issuers to provide such information to the Commission and on their corporate Web sites, if any, in an interactive data format? Should we also permit or require the tagging of executive compensation information even if it is not in the proxy statement, but rather, in the annual report on Form 10-K?[226]
- Are there any other types of information for which we should permit or require tagging in order to improve the efficiency and quality of proxy voting? For example, should we permit or require tagging of information contained in proxy statements filed by non-management parties?
- If we permit or require interactive data for the information contained in a proxy statement, should we permit or require it for only a subset of that

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224 Our solicitation of comment regarding providing proxy statement and voting information in interactive data format is consistent with the Resolution on Tag Data for Proxy and Vote Filings adopted by the Securities and Exchange Commission Investor Advisory Committee. See http://www.sec.gov/spotlight/invadvcomm/iacproposedresproxyvotingtrans.pdf.

225 Currently, there apparently is no standard set of XBRL definitions, or "taxonomy," available to enable an issuer to provide proxy statement and voting information or any subset of such information in XBRL format. XBRL US, however, is developing a taxonomy for at least some information a proxy statement requires. See http://xbrl.us/Learn/Pages/Initiatives.aspx ("Broadridge Financial Solutions contributed a proxy taxonomy to XBRL US in Q4 2008. XBRL US will incorporate the taxonomy into a master digital dictionary of terms.").

226 17 CFR 249.310.

information, such as executive compensation,[227] director experience[228] and other directorships,[229] transactions with related persons,[230] or corporate governance?[231] Should we permit or require it for only a subset of executive compensation information, such as the Summary Compensation Table,[232] Director Compensation Table,[233] Outstanding Equity Awards at Fiscal Year-End Table,[234] or Compensation Discussion and Analysis?[235]

- Would it be useful to investors for issuers to provide their proxy statement and voting information, or some subset of that information, in interactive data format? If so, would it be useful for issuers to provide the information both to the Commission and on their corporate Web sites, if any? Would data-tagging enable investors to access proxy information more easily or to compare information regarding different issuers and/or changes in information over time with respect to a specific issuer or a set of issuers? Would this ability result in better informed voting decisions?

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227 As we noted in Release No. 33-8924, note 220, above, there was substantial interest in financial Web pages that linked to the Executive Compensation Reader that temporarily was posted on our Web site beginning in late 2007. The Executive Compensation Reader displayed the Summary Compensation Table disclosure of 500 large companies that followed the executive compensation rules adopted in 2006 in reporting 2006 compensation information in their proxy statements filed with the Commission. By using the reader, an investor could view amounts included in the Summary Compensation Table Stock Awards and Option Awards columns based on either the full grant date fair value of the awards granted during the fiscal year, or the compensation cost of awards recognized for financial statement reporting purposes with respect to the fiscal year, and recalculate the Total Compensation column accordingly.

228 Item 401(e)(1) of Regulation S-K [17 CFR 229.401(e)(1)].

229 Item 401(e)(2) of Regulation S-K [17 CFR 229.401(e)(2)].

230 Item 404(a) of Regulation S-K [17 CFR 229.404(a)].

231 Item 407 of Regulation S-K [17 CFR 229.407].

232 Items 402(c) and 402(n) of Regulation S-K [17 CFR 229.402(c) and 402(n)].

233 Items 402(k) and 402(r) of Regulation S-K [17 CFR 229.402(k) and 402(r)].

234 Items 402(f) and 402(p) of Regulation S-K [17 CFR 229.402(f) and 402(p)].

235 Item 402(b) of Regulation S-K [17 CFR 229.402(b)].

For instance, should officer and director identities be tagged and linked to their unique Commission Central Index Key (CIK) identifier, which would enable investors to more easily determine whether they have relationships with other Commission filers? Would investors benefit if governance attributes, such as board leadership structure[236] and director independence, were tagged?[237]

- Would requiring issuers to provide proxy statements and voting information in interactive data format assist issuers in automating their business information processing?
- Approximately how much would it cost issuers to provide each of the following in interactive data format:
    - All information contained in a proxy statement;
    - Executive compensation information only; and
    - Voting information disclosed pursuant to Item 5.07 of Form 8-K or Form N-PX?
- With respect to cost, would it be preferable to defer any requirement to tag proxy-related materials until the issuer has been fully phased-in to the financial statement interactive data requirements, or would it be relatively easy to accomplish the tagging of proxy-related materials before, or at the same time as, becoming subject to the financial statement requirements?
- Is it feasible for funds to tag Form N-PX in a manner that provides for uniform identification of each matter voted (e.g., for every fund to assign

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236 Item 407(h) of Regulation S-K [17 CFR 229.407(h)].

237 Item 407(a) of Regulation S-K [17 CFR 229.407(a)].

the same tag to the election of directors at XYZ Corporation) if issuers of portfolio securities do not themselves create these tags by tagging their proxy statements? What alternatives exist, other than having issuers of portfolio securities tag their proxy statements and assign tags to each matter on their proxy statements, that could result in uniform tags being assigned by all funds on Form N-PX to each corporate matter? What would be the costs associated with those alternatives?

- Whether or not we permit or require interactive data tagging, should Form N-PX require standardized reporting formats so that comparisons between funds are easier?
- Should persons other than the issuer be required to file proxy materials in interactive data format?
- How will retail investors have access to interactive data/XBRL software that will enable them to take advantage of interactive data formats?

V. Relationship between Voting Power and Economic Interest

As discussed below, investor and issuer confidence in the legitimacy of shareholder voting may be based on the belief that, except as expressly agreed otherwise, shareholders entitled to vote in the election of directors and other matters have a residual economic (or equity) interest in the company that is commensurate with their voting rights. To the extent that votes are cast by persons lacking such an economic interest in the company, confidence in the proxy system could be undermined. This section examines the possibility of misalignment of voting power in general and three areas in which concerns have been expressed about whether our regulations play a role in the misalignment of voting power from economic interest: the increasingly important role of proxy advisory firms; the impediments in our rules to allowing issuers to set voting record dates that more closely match the date on which voting actually occurs; and hedging and other strategies that allow the voting rights of equity securities to be held or controlled by persons without an equivalent economic interest in the company.

A. Proxy Advisory Firms

1. The Role and Legal Status of Proxy Advisory Firms

Over the last twenty-five years, institutional investors, including investment advisers, pension plans, employee benefit plans, bank trust departments and funds, have substantially increased their use of proxy advisory firms, reflecting the tremendous growth in institutional investment as well as the fact that, in many cases, institutional investors have fiduciary obligations to vote the shares they hold on behalf of their beneficiaries.[238] Institutional investors typically own securities positions in a large number of issuers.

Every year, at shareholders' meetings, these investors face decisions on how to vote their shares on a significant number of matters, ranging from the election of directors and the approval of stock option plans to shareholder proposals submitted under Exchange Act Rule 14a-8,[239] which often raise significant policy questions and corporate

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238 See, e.g., GAO Report to Congress, Corporate Shareholder Meetings – Issues Relating to Firms That Advise Institutional Investors on Proxy Voting (June 2007) ("GAO Report") at 6-7 (attributing the growth in the use of proxy voting advisers, in part, to the Commission's recognition of fiduciary obligations associated with voting proxies by registered investment advisers and its adoption of the proxy voting Advisers Act Rule 206(4)-6(17 CFR 275.206(4)-6), requiring registered investment advisers to "adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the best interest of clients, which procedures must include how you address material conflicts that may arise between your interests and those of your clients").

239 17 CFR 240.14a-8.

governance issues. At special meetings of shareholders, investors also face voting decisions when a merger or acquisition or a sale of all or substantially all of the assets of the company is presented to them for approval.

In order to assist them in exercising their voting rights on matters presented to shareholders, institutional investors may retain proxy advisory firms to perform a variety of functions, including the following:

- Analyzing and making voting recommendations on the matters presented for shareholder vote and included in the issuers' proxy statements;
- Executing votes on the institutional investors' proxies or VIFs in accordance with the investors' instructions, which may include voting the shares in accordance with a customized proxy voting policy resulting from consultation between the institutional investor and the proxy advisory firm, the proxy advisory firm's proxy voting policies, or the institution's own voting policy;
- Assisting with the administrative tasks associated with voting and keeping track of the large number of voting decisions;
- Providing research and identifying potential risk factors related to corporate governance; and
- Helping mitigate conflict of interest concerns raised when the institutional investor is casting votes in a matter in which its interest may differ from the interest of its clients.[240]

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240 See Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003) at text accompanying note 25 (stating that an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party).

Firms that are in the business of supplying these services to clients for compensation – in particular, analysis of and recommendations for voting on matters presented for a shareholder vote – are widely known as proxy advisory firms.[241] Institutional clients compensate proxy advisory firms on a fee basis for providing such services, and proxy advisory firms typically represent that their analysis and recommendations are prepared with a view toward maximizing long-term share value or the investment goals of the institutional client.

Issuers may also be consumers of the services provided by some proxy advisory firms. Some proxy advisory firms provide consulting services to issuers on corporate governance or executive compensation matters, such as assistance in developing proposals to be submitted for shareholder approval. Some proxy advisory firms also qualitatively rate or score issuers' corporate governance structures, policies, and practices,[242] and provide consulting services to corporate clients seeking to improve their corporate governance ratings. As a result, some proxy advisory firms provide vote recommendations to institutional investors on matters for which they also provided consulting services to the issuer. Some proxy advisory firms disclose these dual client relationships; others also have opted to attempt to address the conflict through the creation of "fire walls" between the investor and corporate lines of business.

Depending on their activities, proxy advisory firms may be subject to the federal securities laws in at least two notable respects. First, because of the breadth of the

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241 E.g., GAO Report, note 238, above, at 1.

242 For example, The RiskMetrics Group ("RiskMetrics") publishes "governance risk indicators." Information on these ratings is available at http://www.riskmetrics.com/GRId-info. Proxy advisory firms are not the only types of businesses that offer corporate governance ratings or scores.

definition of "solicitation,"[243] proxy advisory firms may be subject to our proxy rules because they provide recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy. As a general matter, the furnishing of proxy voting advice constitutes a "solicitation" subject to the information and filing requirements in the proxy rules.[244] In 1979, however, we adopted Exchange Act Rule 14a-2(b)(3)[245] to exempt the furnishing of proxy voting advice by any advisor to any other person with whom the advisor has a business relationship from the informational and filing requirements of the federal proxy rules, provided certain conditions are met.[246] Specifically, the advisor:

- Must render financial advice in the ordinary course of its business;
- Must disclose to the person any significant relationship it has with the issuer or any of its affiliates, or with a shareholder proponent of the matter on which advice is given, in addition to any material interest of the advisor in the matter to which the advice relates;

243 Exchange Act Rule 14a-1(l)(iii) [17 CFR 240.14a-1(l)(iii)] defines the solicitation of proxies to include "[t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."

244 See Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Release No. 34-16104 (Aug. 13, 1979) at note 25. Of course, the issue of whether or not a particular communication constitutes a solicitation depends both upon the specific nature and content of the communication and the circumstances under which it is transmitted. See Broker-Dealer Participation in Proxy Solicitations, Release No. 34-7208 (Jan. 7, 1964).

245 17 CFR 240.14a-2(b)(3).

246 See Shareholder Communications and Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Release No. 34-16356 (Nov. 21, 1979) [44 FR 68769]. In 1992, the Commission confirmed that the Rule 14a-2(b)(3) exemption is available to proxy advisory firms that render only proxy voting advice. See Regulation of Communications Among Shareholders, Release No. 34-31326 (Oct. 16, 1992) [57 FR 48276], at note 41.

- May not receive any special commission or remuneration for furnishing the proxy voting advice from anyone other than the recipients of the advice; and
- May not furnish proxy voting advice on behalf of any person soliciting proxies.

Even if exempt from the informational and filing requirements of the federal proxy rules, the furnishing of proxy voting advice remains subject to the prohibition on false and misleading statements in Rule 14a-9.[247]

Second, when proxy advisory firms provide certain services, they meet the definition of investment adviser under the Advisers Act and thus are subject to regulation under that Act. A person is an "investment adviser" if the person, for compensation, engages in the business of providing advice to others as to the value of securities, whether to invest in, purchase, or sell securities, or issues reports or analyses concerning securities.[248] As described above, proxy advisory firms receive compensation for providing voting recommendations and analysis on matters submitted for a vote at shareholder meetings. These matters may include shareholder proposals, elections for boards of directors, or corporate actions such as mergers. We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to maximize the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is

[247] 17 CFR 240.14a-9.

[248] Advisers Act Section 202(a)(11) [15 USC 80b-2(a)(11)]. Sections 202(a)(11)(A) through (G) of the Advisers Act address exclusions to the definition of the term "investment adviser." [15 USC 80b-2(a)(11)(A)-(G)].

intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.

The Supreme Court has construed Section 206 of the Advisers Act as establishing a federal fiduciary standard governing the conduct of investment advisers.[249] The Court stated that "[t]he Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested."[250] As investment advisers, proxy advisory firms owe fiduciary duties to their advisory clients.

In addition, Section 206 of the Advisers Act,[251] the antifraud provision, applies to any person that meets the definition of investment adviser, regardless of whether that person is registered with the Commission. Section 206(1) of the Advisers Act prohibits an investment adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client."[252] Section 206(2) prohibits an investment adviser from engaging in "any transaction, practice or course of business which operates as a fraud or

[249] Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963).

[250] Capital Gains, 375 U.S. at 191-192.

[251] 15 U.S.C. 80b-6.

[252] 15 U.S.C. 80b-6(1).

deceit on any client or prospective client."[253] As we stated recently, the Commission has authority under Section 206(4) of the Advisers Act to adopt rules "reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative."[254] Congress gave the Commission this authority to, among other things, address the "question as to the scope of the fraudulent and deceptive activities which are prohibited [by Section 206]," [255] and thereby permit the Commission to adopt prophylactic[256] rules that may prohibit acts that are not themselves fraudulent.[257]

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253 15 U.S.C. 80b-6(2).

254 Political Contributions by Certain Investment Advisers, Advisers Act Release No. 3043 (July 1, 2010) at 16, citing 15 U.S.C. 80b-6(4). Section 206(4) was added to the Advisers Act in Pub. L. No. 86-750, 74 Stat. 885, at sec. 9 (1960).

255 See H.R. REP. NO. 2197, 86th Cong., 2d Sess., at 7-8 (1960) (stating that "[b]ecause of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit . . . [Section 206(4)] would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of business which are fraudulent, deceptive, or manipulative. This is comparable to Section 15(c)(2) of the Securities Exchange Act [15 U.S.C. 78o(c)(2)] which applies to brokers and dealers."). See also S. REP. NO. 1760, 86th Cong., 2d Sess., at 8 (1960) ("This [section 206(4) language] is almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers."). The Supreme Court, in United States v. O'Hagan, interpreted nearly identical language in section 14(e) of the Securities Exchange Act [15 U.S.C. 78n(e)] as providing the Commission with authority to adopt rules that are "definitional and prophylactic" and that may prohibit acts that are "not themselves fraudulent ... if the prohibition is 'reasonably designed to prevent ... acts and practices [that] are fraudulent.'" United States v. O'Hagan, 521 U.S. 642, 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Securities Exchange Act. See also Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756] (stating, in connection with the suggestion by commenters that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under a particular rule, "We believe our authority is broader. We do not believe that the commenters' suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors.").

256 S. REP. NO. 1760, note 255, above, at 4, 8. The Commission has used this authority to adopt eight rules that address abusive advertising practices, custodial arrangements, the use of solicitors, required disclosures regarding advisers' financial conditions and disciplinary histories, prohibition against political contributions by certain investment advisers ("pay to play"), proxy voting, compliance procedures and practices, and deterring fraud with respect to pooled investment vehicles. 17 CFR 275.206(4)-1; 275.206(4)-2; 275.206(4)-3; 275.206(4)-4; 275.206(4)-5; 275.206(4)-6; 275.206(4)-7; and 275.206(4)-8.

257 See HR. REP. NO. 2197, note 255, above.

Proxy advisory firms also may have to register with the Commission as investment advisers. Whether a particular investment adviser is required to register with the Commission depends on several factors. Investment advisers are generally prohibited from registering with the Commission if they have less than $25 million in assets under management.[258] Congress established this threshold in 1996 to bifurcate regulatory responsibility between the Commission and the states.[259] The Commission retains authority to exempt advisers from the prohibition on registration if the prohibition would be "unfair, a burden on interstate commerce, or otherwise inconsistent with the purposes" of the prohibition.[260]

Proxy advisory firms are unlikely to have sufficient assets under management to register with the Commission because they typically do not manage client assets.[261] Proxy advisory firms may nonetheless be eligible to register because they qualify for one of the exemptions from the registration prohibition under Rule 203A-2 under the Advisers Act. In particular, some proxy advisory firms may be able to rely on the

258 Advisers Act Section 203A [15 USC 80b-3(a)]. If such an adviser is an adviser to an investment company registered under the Investment Company Act, however, it must register with the Commission. See id.

259 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of the United States Code).

260 Advisers Act Section 203A(c) [15 USC 80b-3(c)].

261 For the purpose of calculating assets under management, an adviser must look to those securities portfolios for which it provides "continuous and regular supervisory or management services." See Instruction 5 to Item 5F of Form ADV [17 CFR 279.1].

exemption for "pension consultants"[262] if they have pension plan clients with an aggregate minimum value of $50 million.[263]

Proxy advisory firms that are registered as investment advisers with the Commission are subject to a number of additional regulatory requirements that provide important protections to the firm's clients. For example, registered investment advisers have to make certain disclosures on their Form ADV.[264] Among other things, these disclosures include information about arrangements that the adviser has that involve certain conflicts of interest with its advisory client.[265] In addition, proxy advisory firms that are registered investment advisers are required to adopt, implement, and annually review an internal compliance program consisting of written policies and procedures that are reasonably designed to prevent the adviser or its supervised persons from violating the Advisers Act.[266] Every registered proxy advisory firm that is registered as an

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262 Advisers Act Rule 203A-2(b) [17 CFR 275.203A-2(b)] provides that "[a]n investment adviser is a pension consultant . . . if the investment adviser provides investment advice to: Any employee benefit plan described in Section 3(3) of the Employee Retirement Income Security Act of 1974 ("ERISA") [29 U.S.C. 1002(3)]; Any governmental plan described in Section 3(32) of ERISA (29 U.S.C. 1002(32); or Any church plan described in Section 3(33) of ERISA (29 U.S.C. 1002(33)."

263 See id. A number of proxy advisory firms are currently registered with the Commission under the pension consultant exemption.

264 See Advisers Act Rule 203-1 [17 CFR 275.203-1]. Form ADV consists of two parts. The information provided by advisers in Part I of that form provides the Commission with census-like information on investment adviser registrants and is critical to the examination program in assessing risk and planning examinations. It also requires investment advisers to report disciplinary events of the adviser and its employees. See Advisers Act Rule 204-1 [17 CFR 275.204-1].

265 Part II of Form ADV, or a brochure containing the information in the Form, is required to be delivered to advisory clients or prospective clients by Rule 204-3 under the Advisers Act [17 CFR 275.204-3]. In addition to the disclosure of certain conflicts of interest, Part II contains information including the adviser's fee schedule and the educational and business background of management and key advisory personnel of the adviser. Part II is currently not submitted to the SEC but must be kept by advisers in their files and made available to the SEC upon request and is "considered filed." See Advisers Act Rule 204-1(c) [17 CFR 275.204-1(c)]. Form ADV must be updated at least annually or when there are material changes. See Advisers Act Rule 204-1 [17 CFR 275.204-1].

266 Advisers Act Rule 206(4)-7 [17 CFR 275.206(4)-7].

investment adviser also must designate a chief compliance officer to oversee its compliance program. This compliance officer must be knowledgeable about the Advisers Act and have authority to develop and enforce appropriate compliance policies and procedures for the adviser.[267] A proxy advisory firm that is registered as an investment adviser also is required to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of material non-public information.[268] Proxy advisory firms that are registered as investment advisers also are required to create and preserve certain records that our examiners review when performing an inspection of an adviser.[269]

2. Concerns About the Role of Proxy Advisory Firms

The use of proxy advisory firms by institutional investors raises a number of potential issues. For example, to the extent that conflicts of interest on the part of proxy advisory firms are insufficiently disclosed and managed, shareholders could be misled and informed shareholder voting could be impaired. To the extent that proxy advisory firms develop, disseminate, and implement their voting recommendations without adequate accountability for informational accuracy in the development and application of voting standards, informed shareholder voting may be likewise impaired. Furthermore, some have argued that proxy advisory firms are controlling or significantly influencing shareholder voting without appropriate oversight, and without having an actual economic stake in the issuer.[270] In evaluating any potential regulatory response to such issues, we

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267 Advisers Act Rule 206(4)-7(c) [17 CFR 275.206(4)-7(c)].

268 Section 204A of the Advisers Act [15 USC 80b-4a].

269 Advisers Act Rule 204-2 [17 CFR 275.204-2].

270 See comment letters to Release No. 33-9046, note 7, above, from The Business Roundtable and IBM. It has been suggested, for example, that some issuers have adopted corporate governance

are interested in learning commentators' views regarding appropriate means of addressing these issues, including the application of the proxy solicitation rules and Advisers Act registration provisions to proxy advisory firms. We are also interested in learning commentators' views as to whether these issues are affected – and if so, how – by the fact that there is one dominant proxy advisory firm in the marketplace, Institutional Shareholder Services ("ISS"),[271] whose long-standing position, according to the Government Accountability Office, "has been cited by industry analysts as a barrier to competition."[272]

In order to address these issues, which we describe in additional detail below, we would like to receive views about the role that proxy advisory firms play in the proxy voting process, which could, for instance, assist in determining whether additional regulatory requirements might be appropriate, such as the extent to which oversight of proxy advisory firms registered as investment advisers might be improved. Below we outline the two principal areas of concern about the proxy advisory industry that have come to our attention.

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practices simply to meet a proxy advisory firm's standards, even though they may not see the value of doing so. See GAO Report, note 238, above, at 10.

271 See GAO Report, note 238, above, at 13 (stating that, "[a]s the dominant proxy advisory firm, ISS has gained a reputation with institutional investors for providing reliable, comprehensive proxy research and recommendations, making it difficult for competitors to attract clients and compete in the market"). As of June 2007, ISS's client base included an estimate of 1,700 institutional investors, more than the other four major firms combined. Id. ISS was acquired by RiskMetrics in January 2007, which in turn was acquired on June 1, 2010 by MSCI, Inc. See "MSCI Completes Acquisition of RiskMetrics," (June 1, 2010), available at http://www.riskmetrics.com/news_releases/20100601_msci.

272 GAO Report, note 238, above, at 2.

a. Conflicts of Interest

Perhaps the most frequently raised concern about the proxy advisory industry relates to conflicts of interest.[273] The Government Accountability Office has issued two reports since 2004 examining conflicts of interest in proxy voting by institutional investors.[274] The GAO Report issued in 2007 addressed, among other things, conflicts of interest that may exist for proxy advisory firms, institutional investors' use of the firms' services and the firms' potential influence on proxy vote outcomes, as well as the steps that the Commission has taken to oversee these firms.[275] The GAO Report noted that the most commonly cited conflict of interest for proxy advisory firms is when they provide both proxy voting recommendations to investment advisers and other institutional investors and consulting services to corporations seeking assistance with proposals to be presented to shareholders or with improving their corporate governance ratings.[276]

In particular, this conflict of interest arises if a proxy advisory firm provides voting recommendations on matters put to a shareholder vote while also offering consulting services to the issuer or a proponent of a shareholder proposal on the very

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273 See generally Thompson-Mann Policy Briefing, note 89, above, at 8; GAO Report, note 238, above.

274 GAO Report, note 238, above. The GAO issued an earlier report in 2004 that described, among other things, conflicts of interest in the proxy voting system with respect to pension plans and actions taken to manage them by plan fiduciaries. See GAO, Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting (Aug. 10, 2004), available at http://www.gao.gov/new.items/d04749.pdf.

275 GAO Report, note 238, above. That report noted that the Commission had not identified any major violations in its examinations of such firms that were registered as investment advisers.

276 In its report, GAO described the business model of ISS as containing this particular conflict and noted that the proxy advisory firm took steps to manage the conflict by disclosing the relationships it had with corporate governance clients and implementing policies and procedures to separate its consulting services from proxy voting services. See GAO Report, note 238, above, at 10-11. These potential conflicts of interest of proxy advisory firms are not limited to the United States. See OECD Survey, note 90, above (expressing concern about the integrity of financial intermediaries and the need for more concrete rules).

same matter.[277] The issuer in this situation may purchase consulting services from the proxy advisory firm in an effort to garner the firm's support for the issuer when the voting recommendations are made.[278] Similarly, a proponent may engage the proxy advisory firm for advice on voting recommendations in an effort to garner the firm's support for its shareholder proposals. The GAO Report also noted that the firm might recommend a vote in favor of a client's shareholder proposal in order to keep the client's business.

A conflict also arises when a proxy advisory firm provides corporate governance ratings on issuers to institutional clients, while also offering consulting services to corporate clients so that those issuers can improve their corporate governance ranking.[279] The GAO Report also described the potential for conflicts of interest when owners or executives of the proxy advisory firm have significant ownership interests in, or serve on the board of directors of, issuers with matters being put to a shareholder vote on which the proxy advisory firm is offering vote recommendations. In such cases, institutional investors told the GAO that some proxy advisory firms would not offer vote recommendations to avoid the appearance of a conflict of interest.

It is our understanding that at least one proxy advisory firm provides a generic disclosure of such conflicts of interest by stating that the proxy advisory firm "may" have a consulting relationship with the issuer, without affirmatively stating whether the proxy

277 See GAO Report, note 238, above. Not all proxy advisory firms provide both types of services; some proxy advisory firms differentiate their services by not providing consulting services to corporations. See http://www.ejproxy.com/about.aspx; http://www.glasslewis.com/solutions/proxypaper.php; and www.marcoconsulting.com/2.3.html.

278 See Thompson-Mann Policy Briefing, note 89, above, at 9. See also comment letter to Proxy Disclosure and Solicitation Enhancements, Release No. 33-9052 (July 10, 2009) [74 FR 35076], from Pearl Meyer and Partners, at 12.

279 See Paul Rose, The Corporate Governance Industry, 32 Iowa J. Corp. L. 887, 903 (2007).

advisory firm has or had a relationship with a specific issuer or the nature of any such relationship. Some have argued that this type of general disclosure is insufficient, even if the proxy advisory firm has confidentiality walls between its corporate consulting and proxy research departments.[280]

b. Lack of Accuracy and Transparency in Formulating Voting Recommendations

Some commentators have expressed the concern that voting recommendations by proxy advisory firms may be made based on materially inaccurate or incomplete data, or that the analysis provided to an institutional client may be materially inaccurate or incomplete.[281] To the extent that a voting recommendation is based on flawed data or analysis, issuers have expressed a desire for a process to correct the mistake. We understand, however, that proxy advisory firms may be unwilling, as a matter of policy, to accept any attempted communication from the issuer or to reconsider recommendations in light of such communications. Even if a proxy advisory firm entertains comment from the issuer and amends its recommendation, votes may have already been cast based on the prior recommendation. Accordingly, some issuers have expressed a desire to be involved in reviewing a draft of the proxy advisory firm's report, if only for the limited purpose of ensuring that the voting recommendations are based on accurate issuer data. Some proxy advisory firms have claimed that they are willing to discuss matters with issuers, but that some issuers are unwilling to enter into such discussions.

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280 See generally comment letter to Release No. 33-9052, note 278, above, from Oppenheimer Funds.

281 See, e.g., White Paper on RiskMetrics Report on Target Corporation, available at http://tgtfiles.target.com/empl/pdfs/RMG_Analysis.pdf (identifying asserted inaccurate or misleading statements or assessments in RiskMetrics' report on the 2009 proxy contest involving Target Corporation); Matthew Greco, "New, New Ranking of the Shareholder Friendly, Unfriendly," Securities Data Publishing, May 13, 1996.

There also is a concern that proxy advisory firms may base their recommendation on one-size-fits-all governance approach.[282] As a result, a policy that would benefit some issuers, but that is less suitable for other issuers, might not receive a positive recommendation, making it less likely to be approved by shareholders.

Rule 14a-2(b)(3)'s exemption of proxy advisory firms does not mandate that a firm relying on the exemption have specific procedures in place to ensure that its research or analysis is materially accurate or complete prior to recommending a vote.[283] While voting advice by firms relying on the Rule 14a-2(b)(3) exemption remains subject to the antifraud provisions of the proxy rules contained in Rule 14a-9[284] – and those antifraud provisions should deter the rendering of voting advice that is misleading or inaccurate – it is our understanding that certain participants in the proxy process believe that additional oversight mechanisms could improve the likelihood that voting recommendations are based on materially accurate and complete information. In addition, as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.

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282 The concern regarding a potential one-size-fits-all approach to proxy advice is not limited to U.S. proxy participants. The OECD also has expressed concern that there is a danger of one-size-fits-all voting advice (e.g., applicable to compensation and a box-ticking approach by shareholders minimizing analysis and responsibilities of shareholders) so that a competitive market for advice needs to be encouraged. See OECD, Corporate Governance and the Financial Crisis: Key Findings and Main Messages (June 2009), available at http://www.oecd.org/dataoecd/3/10/43056196.pdf.

283 17 CFR 240.14a-2(b)(3).

284 17 CFR 240.14a-9.

3. Potential Regulatory Responses

a. Potential Solutions Addressing Conflicts of Interest

Revising or providing interpretive guidance on the proxy rule exemption in Exchange Act Rule 14a-2(b)(3)[285] could be one potential solution to the concerns regarding a proxy advisory firm's disclosures about conflicts of interest. Exchange Act Rule 14a-2(b)(3)(ii) requires that a person furnishing proxy voting advice to another person must disclose to its client "any significant relationship" it has with the issuer, its affiliates, or a shareholder proponent of the matter on which advice is given. It appears that some proxy advisory firms currently provide disclosure limited to the fact that the firm "may" provide consulting or other advisory services to issuers. However, we believe that such disclosure should be examined further to determine whether it adequately indicates to shareholders the existence of a potential conflict with respect to any particular proposal. Therefore, we are interested in receiving views on whether this rule should be revised or whether we should provide additional guidance regarding the requirements of this rule. Specifically, we could revise the rule to require more specific disclosure regarding the presence of a potential conflict.

Alternatively, or in addition, we seek comment on whether proxy advisory firms operate the kind of national business or have an impact on the securities markets that Advisers Act Section 203A(c)[286] was designed to address, and whether, as a result, we should establish an additional exemption from the prohibition on federal registration for proxy advisory firms to register with the Commission as investment advisers. We could also provide additional guidance, if necessary, on the fiduciary duty of proxy advisors

285 17 CFR 240.14a-2(b)(3).

286 15 USC 80b-3a(c).

who are investment advisers to deal fairly with clients and prospective clients, and to disclose fully any material conflict of interest. We also could provide guidance or propose a rule requiring specific disclosure by proxy advisory firms that are registered as investment advisers regarding their conflicts of interest, including, for example, on Form ADV.

Finally, in light of the similarity between the proxy advisory relationship and the "subscriber-paid" model for credit ratings, we could consider whether additional regulations similar to those addressing conflicts of interest on the part of Nationally Recognized Statistical Rating Organizations ("NRSROs")[287] would be useful responses to stated concerns about conflicts of interest on the part of proxy advisory firms. For example, such regulations could prohibit certain conflicts of interest and require proxy advisory firms to file periodic disclosures, akin to Form NRSRO, describing any conflicts of interest and procedures to manage them.

287 NRSROs are credit rating agencies that assess the creditworthiness of obligors as entities or with respect to specific securities or money market instruments and that have elected to be registered with the Commission under Section 15E of the Exchange Act. 15 USC 78o-7. Sections 15E and 17 of the Exchange Act provide the Commission with exclusive authority to implement registration, recordkeeping, financial reporting, and oversight rules with respect to NRSROs. 15 USC 78o-7 and 78q.

One commentator has suggested that the Commission's rules that govern NRSROs may be useful templates for developing a regulatory program addressing conflicts of interest and other issues with respect to the accuracy and transparency of voting recommendations provided by proxy advisory firms. Such rules include provisions that: (i) require rating actions to be made publicly available on the NRSRO's Internet Web site [17 CFR 240.17g-2(d)(3)]; (ii) prohibit certain conflicts of interest [17 CFR 240.17g-5(c); Form NRSRO Exhibits 6-7]; (iii) require the disclosure and management of certain other conflicts of interest that arise in the normal course of engaging in the business of issuing credit ratings [17 CFR 240.17g-5(b)]; and (iv) require disclosure of, among other things, performance measurement statistics, sources of information, models and metrics used, qualifications and compensation of analysts, and procedures and methodologies used to determine credit ratings, including procedures for (A) interacting with management of rated issuers, (B) informing issuers of rating decisions, and (C) appealing final or pending rating decisions. [Form NRSRO, Exhibits 1, 2, 8 and 13]. We recognize that the role of NRSROs and proxy advisory firms differ and that following a similar regulatory approach might not be appropriate. We also recognize that the costs and benefits of the NRSRO regulation differ from the costs and benefits of potential additional regulation of proxy advisory firms.

b. Potential Solutions Addressing Accuracy and Transparency in Formulating Voting Recommendations

We have identified a number of potential approaches that might address concerns about accuracy or transparency in the formulation of voting recommendations by proxy advisory firms. For example, proxy advisory firms could provide increased disclosure regarding the extent of research involved with a particular recommendation and the extent and/or effectiveness of its controls and procedures in ensuring the accuracy of issuer data. Proxy advisory firms could also disclose policies and procedures for interacting with issuers, informing issuers of recommendations, and handling appeals of recommendations.[288] We could also consider requiring proxy advisory firms to file their voting recommendations with us as soliciting material, at least on a delayed basis, to facilitate independent evaluation by market participants of the quality of those recommendations.

3. Request for Comment

As discussed above, we are considering the extent to which the voting recommendations of proxy advisory firms serve the interests of investors in informed proxy voting, and whether, and if so, how, we should take steps to improve the utility of such recommendations to investors. In particular, we seek comment on whether we should clarify existing regulations or propose additional regulations to address concerns about the existence and disclosure of conflicts of interest on the part of proxy advisory firms, and about the accuracy and transparency of the formulation of their voting

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288 See, e.g., Thompson-Mann Policy Briefing, note 89, above, at 25 (advocating that a proxy advisory firm should, where feasible and appropriate, prior to issuing or revising a recommendation, advise the issuer of the critical information and principal considerations upon which a recommendation will be based and afford the issuer an opportunity to clarify any likely factual misperceptions).

recommendations. Accordingly, we seek commentators' views generally on proxy advisory firms and invite comment on the following questions:

- Do proxy advisory firms perform services for their clients in addition to or different from those noted above?
- Is additional regulation of proxy advisory firms necessary or appropriate for the protection of investors? Why or why not? If so, what are the implications of regulation through the Advisers Act or the proxy solicitation rules under the Exchange Act? Are any other regulatory approaches equally or better suited to provide appropriate additional regulation? Are there regulatory approaches used in connection with NRSROs that may be appropriate to consider applying to proxy advisory firms?
- Are there conflicts of interest (other than those described above) when a proxy advisory firm provides services to both investors, including shareholder proponents, and issuers? If so, are those conflicts appropriately addressed by current laws, regulations, and industry practices?
- Are there conflicts of interest where a proxy advisory firm is itself a publicly held company? If so, what are they and how should they be addressed?
- What policies and procedures, if any, do proxy advisory firms use to ensure that their voting recommendations are independent and not

influenced by the fees they receive for services to corporate clients or shareholder proponent clients?

- Is the disclosure that proxy advisory firms currently provide to investor clients regarding conflicts of interest adequate? Would specific disclosure of potential conflicts and conflict of interest policies be sufficient, or is some other form of regulation necessary (e.g., prohibiting such conflicts)?
- Do issuers modify or change their proposals to increase the likelihood of favorable recommendations by a proxy advisory firm?
- Do issuers adopt particular governance standards solely to meet the standards of a proxy advisory firm? If so, why do issuers behave in this manner?
- Should proxy advisory firms be required to disclose publicly their decision models for approval of executive compensation plans? Would this alleviate concerns regarding potential conflicts of interest when issuers pay consulting fees for access to such models?
- What is the competitive structure of the market for proxy advisory firms, and what are the reasons for it? Does competition vary across the types of services provided by the proxy advisory firms or the subset of issuers that they cover? Does the industry's competitive structure affect the quality of the recommendations? If there is, as we understand it, one proxy advisory firm that has a significantly larger market share than other firms,[289] does that affect the quality of the recommendations made by that proxy

[289] GAO Report, note 238, above, at 13 (describing ISS as "the dominant proxy advisory firm").

advisory firm or by other proxy advisory firms? Are there any other effects caused by the fact that there is one dominant proxy advisory firm?

- How do institutional investors use the voting recommendations provided by proxy advisory firms? What empirical data exists regarding how, and to what extent, institutional investors vote consistently, or inconsistently, with such recommendations?
- What criteria and processes do proxy advisory firms use to formulate their recommendations and corporate governance ratings? Does the lack of a direct pecuniary interest in the effects of their recommendations on shareholder value affect how they formulate recommendations and corporate governance ratings? Would greater disclosure about how recommendations and corporate governance ratings are generated and how voting recommendations are made affect the quality of the ratings and the recommendations?
- Are existing procedures followed by proxy advisory firms sufficient to ensure that proxy research reports provided to investor clients are materially accurate and complete? If not, how should proxy advisory firms be encouraged to provide investors with the information they need to make informed voting decisions?
- If additional oversight is needed, should it be in the form of regulatory oversight or issuer involvement? Would requiring delayed public disclosure of voting recommendations be an appropriate means to promote accurate voting recommendations?

- Do proxy advisory firms control or significantly influence shareholder voting without appropriate oversight? If so, is there empirical evidence that demonstrates this control or significant influence? If such proxy advisory firms do control or significantly influence shareholder voting, is that inappropriate, and if so, should the Commission take action to address it? If so, what specific action should the Commission take?
- Are there any proxy advisory firms that cannot rely on an exemption to the prohibition on Advisers Act registration? If so, why do the exemptions not apply to those proxy advisory firms?
- Do proxy advisory firms operate the kind of national business that the Advisers Act Section 203A(c) was designed to address? Should we create an additional exemption from the prohibition on federal registration for proxy advisory firms to register as investment advisers? If so, what standard should we use?
- Do the current regulatory requirements for registered investment advisers adequately address advisers whose business is primarily providing proxy voting services? If we consider new rulemaking in this area, what should the rules address? Should we amend Form ADV to require specific disclosures by registered investment advisers that are proxy advisory firms?
- Do proxy advisory firms maintain an audit trail for votes cast on behalf of clients? Do proxy advisory firms monitor whether votes cast are appropriately counted, and if so, how?

B. Dual Record Dates

1. Background

Under state corporation law, issuers set a record date in advance of a shareholder meeting, and holders of record on the record date are entitled to notice of the meeting and to vote at the meeting. State corporation law also governs how far in advance of the meeting a record date can be – typically, no more than 60 days before the date of the meeting.[290] The record date that an issuer selects has implications under the federal securities laws. Our rules require issuers that have a class of securities registered under Section 12 of the Exchange Act and certain investment companies to provide either proxy materials or an information statement to every investor of the class entitled to vote.[291] Additionally, Rule 14a-13 requires that if an issuer intends to solicit proxies for an upcoming meeting and knows that its securities are held by securities intermediaries, it generally must make an inquiry of each such securities intermediary at least 20 business days prior to the record date to ascertain the number of copies of sets of proxy materials needed to supply the materials to the beneficial owners.[292]

Historically, the same record date has been used for determining both which shareholders are entitled to notice of an upcoming meeting and which shareholders are entitled to vote. However, some states are enacting changes to this procedure. For example, effective August 1, 2009, the Delaware General Corporation Law permits, but

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290 See, e.g., Del. Code Ann. tit. 8, § 213(a) ; Model Bus. Corp. Act § 7.05.

291 Additionally, Section 402.04 of the NYSE Listed Issuer Manual provides that "[a]ctively operating issuers are required to solicit proxies for all meetings of shareholders," and NASDAQ Listing Rule 5620(b) provides that "[e]ach Issuer that is not a limited partnership shall solicit proxies and provide proxy statements for all meetings of Shareholders."

292 17 CFR 240.14a-13. Rule 14c-7 contains a parallel requirement for issuers intending to distribute information statements. 17 CFR 240.14c-7.

does not require, Delaware corporations to use separate record dates for making these two determinations.[293] One important result of this change is that it potentially allows an issuer, by establishing a voting record date close to the meeting date, to decrease the likelihood that as of the meeting date persons entitled to vote at the meeting (i.e., the holders on the voting record date) will no longer have an economic interest in the issuer.[294]

2. Difficulties in Setting a Voting Record Date Close to a Meeting Date

Although Delaware's amended statute permits a voting record date[295] to be as late as the date of the meeting itself,[296] certain logistical and legal matters currently prevent

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[293] Del. Code Ann. tit. 8, § 213(a). Section 213 provides that the record date for determining which shareholders are entitled to notice of a meeting "shall not be more than 60 nor less than 10 days before the date of such meeting," and that Unless the board determines otherwise, "such date shall also be the record date for determining the stockholders entitled to vote at such meeting." The August 1, 2009 amendment provides that as an alternative, the board may determine "that a later date on or before the date of the meeting shall be the date for making such determination." Recently proposed amendments to the Model Business Corporation Act, especially §7.07(e) of that Act, adopt a similar approach in permitting dual record dates. See Changes in the Model Business Corporation Act—Proposed Amendments to Shareholder Voting Provisions Authorizing Remote Participation in Shareholder Meetings and Bifurcated Record Dates, 65 Bus. Law. 153, 156-160 (Nov. 2009).

[294] See James L. Holzman and Paul A. Fioravanti, Jr., "Review of Developments in Delaware Corporation Law," Apr. 2009, at 2, available at http://www.prickett.com/PrinterFriendly/Articles/2009_Review_of_Developments.pdf (explaining that the ability to move the voting record date closer to meeting date should promote voting only by those who continue to have an economic interest).

[295] For purposes of this release, the term "voting record date" refers to the date used in determining the stockholders entitled to vote at the meeting, and the term "notice record date" refers to the date used for determining the stockholders entitled to notice of the meeting. "Voting-record-date shareholders" and "notice-record-date shareholders" refer to shareholders who hold their shares as of the record date that is specified.

[296] See Charles M. Nathan, "'Empty Voting' and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds," available at http://lw.com/upload/pubContent/_pdf/pub1878_1.Commentary.Empty.Voting.pdf (explaining that, "[w]ith modern technology, there is no apparent need to retain an advance record date concept to manage shareholder voting. Rather, the record date could be as late as the close of business on the night preceding the meeting, with a voting period (i.e., the time for which the polls remain open) at or in conjunction with the meeting lasting several hours or perhaps a full working day.").

issuers from setting such a voting record date.[297] For example, Rule 14c-2(b) requires that if information statements are being distributed, they must be sent or given to holders of the class of securities entitled to vote at least 20 calendar days prior to the meeting date. Because the investors entitled to receive the information statements, by definition, cannot be identified until the voting record date,[298] issuers intending to distribute information statements currently would be unable to set a voting record date that is fewer than 20 calendar days prior to the corresponding meeting.

We have not adopted a 20 calendar day requirement with respect to proxy materials,[299] but we have stated that "the materials must be mailed sufficiently in advance of the meeting date to allow five business days for processing by the banks and broker-dealers and an additional period to provide ample time for delivery of the material, consideration of the material by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker-dealer to the tabulator."[300]

Additionally,

- Instructions to Schedule 14A, Form S-4, and Form F-4 prescribe certain situations in which, if the materials being sent to shareholders incorporate

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297 Conversely, the record date for traded companies in the United Kingdom must be set at a time that is not more than 48 hours before the time for the holding of the meeting. The Companies (Shareholders' Rights) Regulations 2009 No. 1632 (Regulation 20, section 360B), available at http://www.opsi.gov.uk/si/si2009/uksi_20091632_en_3#pt3-l1g9.

298 Rules 14a-1(h) and 14c-1(h) define "record date" as "the date as of which the record holders of securities entitled to vote at a meeting or by written consent or authorization shall be determined" (emphasis added).

299 We note, however, that Section 401.03 of the NYSE Listed Issuer Manual "recommends that a minimum of 30 days be allowed between the record and meeting dates so as to give ample time for the solicitation of proxies."

300 Release No. 34-33768, note 4, above.

information by reference, the issuer must send its proxy statement or prospectus to investors at least 20 business days before the meeting;[301]

- Rule 14a-16(a)(1) requires issuers not relying on the full set delivery option to provide a Notice of Internet Availability of Proxy Materials at least 40 calendar days before the meeting date;[302] and
- Certain of our rules and forms require that if a limited partnership roll-up transaction is being proposed, the disclosure document must be distributed no later than the lesser of 60 calendar days prior to the meeting date or the maximum number of days permitted for giving notice under applicable state law.[303]

Because these provisions require a period of time between the mailing of materials and the meeting date and because, under a dual record date system, the investors to whom the materials must be mailed (that is, those investors entitled to vote at the meeting) would not be identified until the voting record date, [304] issuers are limited in how close to the meeting date their voting record date can be.

Issuers also need to consider logistical matters in deciding the timing of their voting record date and their mailing. They need to find out how many copies of their materials to print, print the materials, and distribute the materials to transfer agents and to

301 See Note D.3 to Schedule 14A, General Instruction A.2 to Form S-4, and General Instruction A.2 to Form F-4.

302 17 CFR 240.14a-16(a)(1).

303 Section 14(h)(1)(J) of the Exchange Act, Rule 14a-6(l), Rule 14c-2(c), General Instruction I.2 to Form S-4, and General Instruction G.2 to Form F-4.

304 Under our rules, the issuer must send an information statement to all shareholders entitled to vote at a meeting, but from whom no proxy is being solicited. 17 CFR 240.14c-2. Thus, the issuer effectively must send either a proxy statement or an information statement to any shareholder entitled to vote at a meeting, including those that acquire the securities after the notice record date, but before the voting record date.

proxy service providers so that they can be delivered to registered and beneficial owners. Exchange Act Rules 14a-13, 14b-1, 14b-2, and 14c-7 govern this process, but we understand that in practice those rules reflect only a subset of the time-consuming logistical hurdles issuers need to go through. In this release, we are inviting submission of additional information on this process and suggestions for streamlining it.

3. Potential Regulatory Responses

In light of the changes to state law, we seek to explore whether to propose action to accommodate issuers that wish to use separate record dates where permitted by state law, and if so, what action we should take. In analyzing this situation, we are faced with competing considerations. On one hand, the closer to a meeting date a voting record date is, the more likely it is that investors who are entitled to vote will still have an economic interest in the issuer at the time of the shareholder meeting. Thus, setting the voting record date close to the meeting date avoids disenfranchising the shareholders who purchase their shares after the record date for notice of the meeting. Moreover, facilitating the use of a notice record date that significantly precedes a voting record date may assist shareholders in recalling loaned securities in order to vote them. On the other hand, investors who are entitled to vote need adequate time to receive the proxy materials and consider the matters presented to them for approval. Inadequate time can lead to uninformed voting decisions or, in some cases, a decision by the investor not to vote at all, a problem that was highlighted in 2007 as we considered adopting the notice and access rules.[305]

[305] See Release 34-55146, note 199, above, at note 25.

If we choose to facilitate issuers' use of separate record dates, we could choose between two general models, one focusing principally on the notice record date and the other focusing principally on the voting record date. The first model would be to require issuers to provide proxy materials or an information statement, as applicable, to those who are investors as of the notice record date. This model parallels the Delaware provision in that it focuses the information-delivery obligation on persons who are investors as of the notice record date. One open question under this first model is whether issuers should subsequently be obligated to send the disclosure document to those who were not investors as of the notice record date but who become investors by the voting record date.[306]

The second model would be to require issuers to provide the disclosure document to those who are investors as of the voting record date. An open issue under this model is whether and how issuers should be obligated to make the disclosure document public at some point before the voting record date.

Under either model, it is possible that some investors will obtain a proxy card or VIF, fill it out and submit it, and then buy additional shares or sell some shares, all prior to the voting record date. Thus, the number of shares held at the time of submission of the proxy or VIF may differ from the number of shares that are ultimately voted on behalf of the investor. In such a situation, we would need to consider how the proxy or VIF already submitted by the investor would be affected, as well as the legal and operational implications that this situation may impose on broker-dealers and their customers and the

[306] The theory for not imposing this requirement would be that voting-record-date shareholders will have the information available to them if they desire to see it. The information will be available on the Internet pursuant to Rule 14a-16(b)(1) and (d), and in many cases press releases and media reports would publicize the availability of the information.

costs associated with developing a process to address it, in light of the complex beneficial ownership structure described earlier in this release.

Investors may benefit from receiving information about the effect that trades subsequent to the submission of their proxy or VIF will have on their voting rights. Therefore, additional disclosure may be necessary in proxy and information statements. One possible disclosure would be to establish that if an investor submits a proxy or VIF prior to the voting record date, all of the shares held by the investor as of the voting record date would be voted in accordance with the proxy or VIF, in the absence of specific contrary instructions from the investor.[307] Another alternative would be to clarify that a proxy or VIF would not be used to vote more shares than the investor held at the time he or she submitted the proxy or VIF, so that shares acquired after the notice record date would not be voted unless that investor submits a separate proxy or voting instruction for those shares. However, it appears that each of these approaches may risk undermining the purpose of facilitating a voting record date that is closer to the meeting date.

4. Request for Comment

- Do issuers wish to use dual record dates? If so, why?
- The Delaware amendment became effective on August 1, 2009. Should we first see how popular the dual-record-date provision is before providing a regulatory response? Or, are our rules an impediment to using dual record dates, so that it is difficult to assess whether this new approach

307 The investor would, of course, continue to be able to revise his or her previous votes prior to the meeting.

would be viewed favorably by issuers or investors unless we change our rules?

- In view of the competing policy considerations described above, if we respond, should we respond in a way that generally facilitates issuers' ability to use the dual-record-date approach or in a way that discourages it? Which direction would be better for investors? Is there a more neutral approach that would better serve the interests of investors?
- Even if it is too early for us to take action that either facilitates or discourages issuers' use of dual record dates, does the mere existence of a two-record-date regime create confusion or uncertainty in the interpretation of any of our existing rules? If so, which rules need to be clarified or revised? For example, should we consider proposing to clarify or to revise:
    - Rules 14a-1(h) and 14c-1(h), which define "record date" as, essentially, the voting record date;
    - Item 6(b) of Schedule 14A, which requires issuers to "[s]tate the record date, if any, with respect to this solicitation"; or
    - Rules 14a-13(a)(3) and 14c-7(a)(3), which require issuers to send an inquiry at least 20 business days prior to the record date?
- Would any SRO rules or recommendations need to be revised or clarified in order to facilitate the use of dual record dates?
- Under the first model described above, after an issuer distributes its disclosure document to investors as of the notice record date, the issuer

might need to send the disclosure document, or at least a notice of the availability of the disclosure document, to those who become investors after the notice record date but before the voting record date.

- Would this obligation be appropriate?
- If not, how would new investors obtain the means to vote, such as a proxy card, a VIF, or a control number to vote electronically or telephonically? Would they be limited to attending the meeting in person? Would new beneficial owners be able to vote or attend at all?
- Given that the investors who are entitled to vote are the investors as of the voting record date, would the first model (in which some investors who ultimately would not be entitled to vote would receive proxy materials) serve any useful interest if such an obligation were not imposed?
- If we do not impose such an obligation on issuers, should they be able to choose which new investors to send the disclosure document to, or should an "all or none" requirement apply? If they should have a choice, on what basis should they be able to choose?
- Finally, what impact would the first model have on the costs of distributing proxy materials?

- Under the second model described above, because the voting record date might be close to, or on, the meeting date, would it be necessary to require issuers to make public their disclosure document at some point before the voting record date? What would be the most appropriate way for them to do so, and how far in advance of the voting record date or the meeting date should they be required to do so? Should we consider different requirements for different sizes of issuers (for example, permit more reliance on media outlets and less reliance on physical mailings for larger issuers)?

- Which of the two general approaches outlined above is more appropriate? What other general approaches should we consider?
- Would broker-dealers be able, or have sufficient time, to track accurately which beneficial owners would have the right to vote on the voting record date if it is close to the shareholder meeting? If so, what would be the cost to broker-dealers to establish such tracking systems?
- As discussed above, some of our rules specify a minimum number of days before a meeting by which an issuer must distribute its disclosure document. Should we consider shortening or eliminating any of these time periods? If we shorten any of them, what is an appropriate amount of time to replace it with?
- Should we propose to specify a minimum number of days that must elapse between the mailing of a proxy statement and a meeting, as Rule 14c-2(b) does with information statements? If we were to do so, what would be an appropriate number of days, and should the number be flexible to account for such possibilities as overnight or electronic delivery, or electronic or

telephonic voting?[308] In what ways can or should we rely on technology to reduce these time periods?

- Should we propose that federal proxy rules prescribe a form of proxy that permits the shareholder to specify the extent to which an executed proxy should be applied to shares that are bought after the proxy is submitted and before the voting record date?
- Would voting all of the shares in accordance with the instructions on the proxy or VIF present issues under Rule 14a-10(b), which prohibits the solicitation of "any proxy which provides that it shall be deemed to be dated as of any date subsequent to the date on which it is signed by the security holder"? If so, should that rule be amended, and how?

C. "Empty Voting" and Related "Decoupling" Issues

1. Background and Reasons for Concern

As noted in the Introduction, this release primarily focuses on whether the U.S. proxy system operates with the accuracy, reliability, transparency, accountability, and integrity that shareholders and issuers should rightfully expect. These expectations are shaped in part by the Commission's proxy solicitation, disclosure and other rules, the rules of the national securities exchanges, as well as by the substantive rights granted under state corporate law and the charter and bylaw provisions of individual corporations.

308 The OECD recommends that measures should be taken, both by regulators and by all the institutions involved in the voting chain (issuers, custodians, etc.) to remove obstacles and to encourage the use of flexible voting mechanisms such as electronic voting. Corporate Governance and the Financial Crisis – Key Findings and Main Messages, note 282, above.

At their core, these expectations are based on the foundational understanding that, absent contractual or legal provisions to the contrary, a "shareholder" possesses both voting rights and an economic interest in the company.

The ability to separate a share's voting rights from the economic stake through, for instance, what has been dubbed "empty voting" and "decoupling" challenges this foundational understanding.[309] The term "empty voting" has been defined to refer to the circumstance in which a shareholder's voting rights substantially exceed the shareholder's economic interest in the company.[310] In this circumstance, the exercise of the right to vote is viewed as "empty" because the votes have been emptied of a commensurate economic interest in the shares (and, at the extreme, may even be associated with a negative economic interest in the sense of benefiting from a decline in the share price). Here, the bundle of rights and obligations customarily associated with share ownership has been "decoupled." Empty voting is an example of decoupling and can occur in a variety of ways, some of which we describe briefly below.

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309 See, e.g., Henry T. C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 University of Pennsylvania Law Review 625-739 (2008) [hereinafter, Hu & Black, Empty Voting II]; Henry T. C. Hu & Bernard Black, Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications, 14 European Financial Management 663-709 (2008) [hereinafter Hu and Black, Debt and Hybrid Decoupling]. Henry Hu currently serves as the Director of the Division of Risk, Strategy, and Financial Innovation at the Commission.

310 For the purposes of this release, empty voting does not include dual class or similar share structures in which the corporate charter prescribes disproportionate allocation of voting and economic rights, albeit in a fully disclosed fashion. Likewise, for purposes of this release empty voting does not encompass the situation in which the individuals within an institutional investor who determine that investor's voting decisions act independently of the person or persons making economic investment decisions in regard to the security being voted. See, e.g., Charles M. Nathan & Parul Mehta, The Parallel Universes of Institutional Investing and Institutional Voting (Mar. 6, 2010), available at http://www.lw.com/upload/pubContent/_pdf/pub3463_1.pdf; cf. James McRitchie, Parallel Universes Undercuts Its Own Arguments (Apr. 16, 2010), available at http://corpgov.net/wordpress/?tag=nathan. Unlike the dual class situation, this latter situation could involve undisclosed decoupling of voting decisions from economic considerations.

Such decoupling raises potential practical and theoretical considerations for voting of shares. For example, an empty voter with a negative economic interest in the company may prefer that the company's share price fall rather than increase. Such a person's voting motivation contradicts the widely-held assumption that equity securities are voted based on an interest in increasing shareholder value and in a way to protect shareholders' interests or enhance the value of the investment in the securities. That assumption—a core premise of state statutes requiring shareholder votes to elect directors and approve certain corporate decisions—may be undermined by the possibility that persons with voting power may have little or no economic interest or, even worse, have a negative economic interest in the shares they vote. It is a source of some concern that elections of directors and other important corporate actions, such as business combinations, might be decided by persons who could have the incentive to elect unqualified directors or block actions that are in the interests of the shareholders as a whole. Significant decoupling of voting rights from economic interest could potentially undermine investor confidence in the public capital markets.[311]

On the other hand, empty voting may not always be contrary to the interests of shareholders. One article argues, for instance, that informed investors[312] could potentially improve electoral outcomes through empty voting by taking long economic

311 For an academic analysis of many of the efficiency-related effects of equity decoupling, positive as well as negative, see Hu & Black, Debt and Hybrid Decoupling, note 309, above, at 667-672. For a discussion of how outsiders as well as incumbent management (e.g., managers, controlling shareholders, and corporations themselves) may try engaging in equity decoupling strategies, see Hu & Black, Empty Voting II, note 309, above, at 628-654 and 661-681.

312 We do not express an opinion as to whether any particular class of investor will always make a shareholder-maximizing vote. For purposes of this discussion, it is sufficient to assume that, generally speaking, a highly informed investor is more likely to vote in a manner that will add to shareholder value than a less informed investor.

positions, acquiring disproportionate voting power from less informed shareholders,[313] and casting votes that are more informed and thus more likely to contribute to shareholder value.[314]

As discussed below, regardless of whether empty voting is deemed to be "good" or "bad," there is a strong argument for ensuring that there is transparency about the use of empty voting. If a voter acquires shares with a view to influencing or controlling the outcome of a vote but takes steps to reduce the risk of economic loss or even achieve a negative economic interest, disclosure of the empty voter's status and intentions could be important information to other shareholders.[315]

The Commission needs to further evaluate empty voting and related techniques in order to properly review the reliability, accuracy, transparency, accountability, and integrity of the current proxy system and the challenges that may be posed by empty voting and related techniques. Therefore, we are seeking information on the myriad ways in which decoupling can occur, and its nature, extent, and effects on shareholder voting and the proxy process.[316] We understand that responses explicitly intended to address

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313 Notably, the nature of the decoupling in these circumstances is qualitatively different than that in which a person holding the right to vote has no economic interest, or a negative economic interest, in the issuer. Rather, such an investor has a positive economic interest, and while there is decoupling insofar as that investor holds voting rights that derive from shares owned by a different investor, that investor has voting interests that are aligned with the economic interest of investors generally.

314 See Susan E. K. Christoffersen, Christopher C. Geczy, David K. Musto, and Adam V. Reed, Vote Trading and Information Aggregation, Journal of Finance, Vol. 62, 2007, pp. 2897–2929.

315 Item 6 of Schedule 13D requires disclosure of contracts, arrangements, understandings, or relationships with respect to the securities covered by the Schedule, but the filing of Schedule 13D is triggered only when a person owns greater than 5% of a Section 12-registered equity security, as such ownership is calculated according to the pertinent rules.

316 Separately, as described in Section V.C.2.b, below, the staff has initiated a project to review longstanding requirements as to disclosure of holdings of securities. The information gathered in connection with both projects, as well as any rule changes that may flow from such projects, could be helpful to the Commission, as well as to shareholders, issuers and state legislatures.

aspects of empty voting have already started to occur at the state corporate law and individual corporation level.[317]

2. Empty Voting Techniques and Potential Downsides

a. Empty Voting Using Hedging-Based Strategies

A variety of techniques can be used to accomplish empty voting. One technique is to hold shares but to hedge the economic interest in those shares. A shareholder could hedge that economic interest in a wide variety of ways, including by buying either exchange-traded or OTC put options. In a recent Commission enforcement action, a registered investment adviser agreed to settle charges that it had violated Section 13(d) of the Exchange Act in furtherance of a strategy of "essentially buying votes."[318] The investment adviser purchased shares of a prospective acquirer "for the exclusive purpose of voting the shares in a merger and influencing the outcome of the vote" on a proposed acquisition of a company in which the investment adviser owned a large block of stock.[319] At the same time, the investment adviser entered into swap transactions with the banks from which it purchased the acquirer's shares, so that it "was able to acquire the voting rights to nearly ten percent of [the acquirer]'s stock without having any economic risk

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317 For example, Delaware has amended its General Corporation Law to allow corporations to adopt measures to respond to certain record date capture strategies. See Bryn Vaaler, United States: DGCL Amendments Authorize Proxy Access And Expense Reimbursement Bylaws, Reverse Schoon v. Troy Corp., Mondaq Business Briefing, May 12, 2009, available at http://www.mondaq.com/unitedstates/article.asp?articleid=79322. Some corporations have adopted bylaws that, under certain circumstances, require shareholders submitting a proposal to disclose how they have hedged the economic interests associated with their share positions. See Matt Andrejczak, "Sara Lee, Coach set rules to deter devious shareholders," MarketWatch, Apr. 2, 2008.

318 See In the Matter of Perry Corp., Release No. 34-60351, July 21, 2009 at ¶19, available at http://www.sec.gov/litigation/admin/2009/34-60351.pdf.

319 Id. at ¶33.

and no real economic stake in the company, [and] was able to do this without making a significant financial outlay."[320]

While the practice of empty voting was not asserted as a substantive violation in the enforcement action, the matter illustrates how hedging techniques can be used to obtain voting power without having economic exposure on the securities being voted. The use of hedging by insiders also can result in empty voting. Executives entering into "collars" transactions, for instance, retain full voting rights despite having hedged a portion of their economic interest.[321]

Empty voting can also be accomplished by the use of credit derivatives (rather than through the use of put options and other equity derivatives), a process dubbed "hybrid decoupling."[322] For example, instead of using put options to hedge its economic interest in shares, a shareholder may enter into credit default swap transactions with a derivatives dealer. If a company experiences poor economic performance, the likelihood of the company defaulting on its debt increases, and so the shareholder's credit default swap holdings will likely rise in value.[323]

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320 Id. at ¶18.

321 In a "collar" transaction, the investor sells a call option at one strike price and purchases a put option at a lower strike price. For little or no cost, the investor thereby limits the potential for appreciation or depreciation to the range – the "collar" – defined by the two strike prices. Academic research indicates that CEOs, directors, and senior executives have used this strategy to hedge their economic interest in the firm's stock. See Carr Bettis, John Bizjak, and Michael Lemmon, Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders, Journal of Financial and Quantitative Analysis, 2001, at 3.

322 See Hu & Black, Debt and Hybrid Decoupling, note 309, above, at 688-690.

323 And just as "equity decoupling" and "hybrid decoupling" could sometimes incentivize some shareholders to use their voting rights against the best interests of the company and other shareholders, some believe that a pattern that has been termed "debt decoupling" – the unbundling of the economic rights, contractual control rights, and other rights normally associated with debt – may sometimes raise incentive issues as to some debtholders. These debtholders, dubbed "empty creditors," may sometimes even have the incentive to use the control rights the debtholders have in their loan agreements or bond indentures to try to cause a company to go into bankruptcy. See Hu

Finally, hedging-based strategies need not even involve holding either the debt or equity of the company in which the shareholder is voting, or derivatives linked to such debt or equity. A shareholder may, for instance, be able to hedge its exposure to a company's shares through purchasing assets correlated in some fashion to the company's share price. In the case of an acquisition, for example, a shareholder in the potential acquirer which also holds a larger equity interest in the target company, may arguably be characterized as being an empty voter with a negative economic interest in the acquirer. That is, the more the acquirer overpays for the target, the more net profit the investor would achieve. Other correlated assets that may be used in empty voting strategies may include, for example, shares of a competitor or a supplier.

b. Empty Voting Using Non-Hedging Based Strategies

There are a variety of situations in which empty voting may arise without any hedging at all. For example, active trading between a voting record date and the actual voting date may result in many voters having voting rights different from their economic stakes. An investor who sells shares after the voting record date retains the right to vote the shares without having any economic interest in them. Another example of empty voting without hedging is the voting of employees' unallocated shares in an employee stock ownership plan ("ESOP"). In an ESOP, while employees only have a contingent economic interest in the unallocated shares, the shares have full voting rights and are voted by a trustee, who either exercises discretion in voting or votes in proportion to

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& Black, Debt and Hybrid Decoupling, note 309 above, at 665-66 and 679-688; "CDSs and bankruptcy – No empty threat," The Economist, June 18, 2009.

vested ESOP shares. Effectively, either the trustee or the employees may become empty voters.[324]

One important non-hedging based technique that appears to have been used outside the United States is borrowing shares in the stock lending market. Under standard stock lending arrangements, the borrower of the shares has the voting rights associated with the shares borrowed, but relatively little or no economic interest in the shares.[325] Thus, simply by paying a fee to borrow the shares, the borrower can "buy" votes associated with the shares without having any corresponding economic interest. And the size of the fee could be reduced by borrowing the shares immediately before the record date, and returning the shares immediately afterwards.[326] Within the U.S. this sort of practice appears to be limited by Regulation T, under which securities loans by institutional investors through their broker-dealers are restricted to distinct "permitted purposes" under the Federal Reserve Board's Regulation T, such as execution of a short sale.[327] Borrowing securities to obtain the right to vote, however, may occur outside the purview of Regulation T in certain circumstances.

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324 See Hu & Black, Empty Voting II, note 309 above, at 648-651 (as to restricted stock voting rights and certain ESOPs).

325 See, e.g., Master Securities Lending Agreement at 7.1-7.5, note 72, above.

326 Some observers believe that this stock lending-based strategy has occurred in Hong Kong and the United Kingdom. See Kara Scannell, "Outside Influence: How Borrowed Shares Swing Company Votes – SEC and Others Fear Hedge-Fund Strategy May Subvert Elections," Wall Street Journal, Jan. 26, 2007, at page A1.

327 See Federal Reserve Board Regulation T, 12 C.F.R. §220.2. This regulation limits the purposes for which broker-dealers who do not transact with customers from the general public may lend shares. Regulation T's "purpose test" generally provides that borrowers may only borrow securities for short selling, covering delivery fails, and similar purposes. For a fuller description of Regulation T, see Charles E. Dropkin, "Developing Effective Guidelines for Managing Legal Risks-U.S. Guidelines," Securities Lending and Repurchase Agreements 167, 172-176 (Frank J. Fabozzi and Steven V. Mann, eds., 2005). Essentially, Regulation T requires broker-dealers to make a good faith effort to ascertain the borrower's purpose and cannot lend shares for voting purposes because that is not a permitted purpose under Regulation T. 17 CFR 220.10(a). The standard securities lending agreement in the U.S. generally will contain a representation and

3. Potential Regulatory Responses

As one possible response to empty voting and related phenomena, the Commission could consider requiring disclosure that creates transparency.[328] The proxy rules, the periodic reporting system, and rules adopted pursuant to statutory provisions such as Sections 13(d), 13(f), and 13(g) of the Exchange Act might be modified or a new disclosure system could be developed to elicit fuller disclosure of empty voting. More robust disclosure may be helpful to all of the participants in the proxy process as well as for regulators. For instance, if an investor acquires substantial voting rights that are not disclosed, then the other shareholders may not be aware of the potentially heightened importance of their vote. Without such information, shareholders may have insufficient information as to the need to vote and to take coordinated or other actions to protect their interests. By improving transparency, investors would have the option to choose to respond to such information and make a better informed investment or voting decision. Issuers also may be in a position to take responsible and appropriate action in response to disclosure of empty voting strategies, such as increasing their solicitation efforts.

Beyond gathering information and enhancing transparency, the following are some of the possible responses to empty voting and other types of decoupling that could be considered by the Commission, Congress, state legislatures, and individual issuers.

- Require voters to certify on the form of proxy or VIF that they held the full economic interest in the shares being voted at the time the proxy was

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warranty that the borrower, and any person to whom the borrower relends the borrowed securities, are only borrowing consistent with the "purpose test" (unless the borrowed securities are "exempted securities"). See, e.g., Master Securities Lending Agreement, note 72, above, at 9.5 (at www.sifma.org/services/stdforms/pdf/master_sec_loan.pdf).

328 The staff is also working on the separate but related project of reviewing current disclosure requirements relating to holdings of financial instruments, including short sale positions and derivatives positions.

executed, or, if not, disclose the extent to which their economic interest in the shares was shorted or hedged.

- Require disclosure of the shareholder meeting agenda sufficiently ahead of the record date to enable investors who have loaned their securities to recall those loans to retain voting control of those securities.[329]
- Permit only persons who possess pure long positions (i.e., economic interests not shorted or hedged) in the underlying shares to vote by proxy, or allow proxy voting only commensurate with their net long positions (e.g., economic interests after adjusting for equity or credit derivative-based hedging or short positions), or require a cooling-off period for those who have no or negative economic interests (after public disclosure) before voting.
- Prohibit empty voting, especially in situations where there is a negative economic interest.

4. **Request for Comment**

- What is the potential for, and actual prevalence of, all forms of equity, debt, and hybrid decoupling (including empty voting)? Are these techniques employed differently by "outside" investors, company insiders, and the company itself? Does decoupling raise public policy concerns, for example in relation to the disclosure requirements of Section 13(d)? Are existing disclosure requirements under Section 13(d) and other provisions

[329] See Section III.C.2, above.

of federal securities laws sufficient to address the entire range of concerns raised by equity, debt, and hybrid decoupling?

- Can the potentially beneficial and potentially detrimental aspects of debt, equity, or hybrid decoupling be meaningfully distinguished? Are there adverse consequences if there are empty voters, or even empty voters with negative economic interests, especially if their votes are outcome determinative? Are there examples of situations in which empty voting was outcome determinative?
- What are the mechanisms that result in debt, equity, and hybrid decoupling giving rise to public policy concerns? How important are these different mechanisms? To what extent can credit derivatives, correlated assets (such as, for example, shares of other participants in a takeover battle), or other financial instruments be used, and to what extent are they being used, to accomplish empty voting? To what extent does debt decoupling raise issues similar to those raised by equity decoupling or hybrid decoupling and how might regulatory or other responses to debt decoupling differ?
- At what economic threshold or percentage of voting power threshold is decoupling—by any one individual, by group, or by shareholders in the aggregate—material to the company and its security holders?
- Are certain companies (for instance, due to their ownership or capital structure) particularly vulnerable to potential adverse effects of debt, equity, or hybrid decoupling?

- Do concerns about decoupling economic interests and voting rights extend to the decoupling of voting and investment management functions within institutional investors?[330] If so, would one or more regulatory responses, involving disclosure or otherwise, be appropriate?
- Under what circumstances should disclosure of a shareholder's net economic interest be required, along with any associated decoupling? If such net economic interest is required to be disclosed, how should "net economic interest" be defined, given the myriad ways in which such decoupling can occur? Should our rules require disclosure regarding, and/or certification of, beneficial and economic ownership as part of the form of proxy or VIF? Or should this matter be left to state law or bylaws adopted by individual companies?
- If companies and company executives themselves engage in decoupling, do existing disclosure requirements result in sufficient transparency for investors to observe this behavior? If not, what level of disclosure would provide sufficient transparency? What changes to Schedules 13D or 13G, periodic disclosure requirements, Securities Act disclosure rules, the proxy rules, or other aspects of securities law are advisable?
- Are there circumstances (such as empty voting while holding a negative economic interest) where debt, equity, and hybrid decoupling appear to be fundamentally detrimental to the shareholders, debtholders, or the issuer itself? Are existing disclosure requirements, or changes to existing

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330 See Nathan & Mehta, note 310, above.

disclosure requirements, sufficient to address any such concerns? Should the Commission consider additional remedial actions? What role should federal law, state law and individual corporate actions play in addressing any such concerns?

- Should we propose rule changes to provide more disclosure and transparency as to equity, debt, or hybrid decoupling? If so, should this disclosure be in proxy solicitation materials, periodic reports, or disclosures pursuant to Sections 13(d), 13(g), and/or 13(f)? Should we develop a specific new form or report relating to short sales, short sale positions, and debt, equity, or other derivatives that could be used to identify instances of potential or actual empty voting or other kinds of equity, debt, or hybrid decoupling? Should any requirements related to decoupling disclosure also require disclosure of credit derivatives positions, as would occur with hybrid decoupling? Should debt decoupling be subject to disclosure requirements and, if so, what disclosure requirements would be appropriate? To what extent would new legislation be necessary in order to impose any of these requirements?
- If we were to propose any enhanced or new disclosure requirements, what should the filing deadlines be under various circumstances in order to inform the marketplace on a timely basis, while providing adequate time for those responsible for complying with the requirement to collect the information and prepare the filing?

- What should be the triggers for such disclosure requirements? For instance, in establishing such a trigger, is the more than 5% equity ownership threshold of Exchange Act Section 13(d) analogous in any way? Are the current "beneficial owner" concepts contemplated by Regulation 13D-G, some variation of such concepts, or some altogether different concept of ownership appropriate for determining whether a disclosure requirement is triggered? Or should decoupling-related disclosures not be based on conceptions of ownership, but instead be based on the nature of the investor and presence of investment discretion, as with Form 13F? Are there alternatives to "ownership," the nature of the investor, and presence of investment discretion that should be considered?
- What level of detail should be required for decoupling-related disclosures, recognizing the complexity of, for example, many OTC derivatives?
- If, pursuant to state law or a company's articles or bylaws, there are substantive limitations on empty voting or other forms of decoupling, should the Commission accommodate the implementation of such limitations by, for instance, requiring disclosure or ownership certifications on the form of proxy or VIF?
- To what extent is Regulation T, by its terms, effective in limiting the borrowing of shares for voting purposes? Should the Commission or another regulator propose a new rule that would prohibit or restrict borrowing securities for purposes of obtaining the right to vote those securities?

VI. Conclusion

The U.S. proxy system is the fundamental infrastructure of shareholder suffrage since the corporate proxy is the principal means by which shareholders exercise their voting rights. The development of issuer, securities intermediary, and shareholder practices over the years, spurred in part by technological advances, has made the system complex and, as a result, less transparent to shareholders and to issuers. It is our intention that this system operate with the reliability, accuracy, transparency, and integrity that shareholders and issuers should rightfully expect.

We are interested in the public's opinions regarding the matters discussed in this concept release. We encourage all interested parties to submit comment on these topics. In addition, we solicit comment on any other aspect of the mechanics of proxy distribution and collection that commentators believe may be improved upon.

By the Commission,

Elizabeth M. Murphy
Secretary

Dated: July 14, 2010

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62499 / July 14, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3153 / July 14, 2010

Admin. Proc. File No. 3-13935

In the Matter of L. REX ANDERSEN, CPA	ORDER

On June 10, 2010, we issued an order instituting proceedings ("OIP") against L. Rex Andersen, a certified public accountant, pursuant to Commission Rule of Practice 102(e)(3),[1] that temporarily suspended him from appearing or practicing before the Commission as an

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[1] Commission Rule of Practice 102(e)(3), 17 C.F.R. § 201.102(e)(3), provides in pertinent part that:

> (i) The Commission, with due regard to the public interest and without preliminary hearing, may, by order, temporarily suspend from appearing or practicing before it any . . . accountant . . . who has been by name:
>
> > (A) Permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder; or
> >
> > (B) Found by any court of competent jurisdiction in an action brought by the Commission to which he or she is a party or found by the Commission in any administrative proceeding to which he or she is a party to have violated (unless the violation was found not to have been willful) or aided and abetted the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

accountant.[2] On June 15, 2010, Andersen filed a petition, pursuant to Rule 102(e)(3)(ii),[3] challenging the Commission action and requesting that the matter be set down for hearing.

I.

The proceedings were instituted based on Andersen's having been enjoined from violating Securities Exchange Act Section 10(b), Exchange Act Rule 10b-5[4] and Rule 2-02 of Regulation S-X,[5] and from aiding and abetting violations of Exchange Act Section 13(a)[6] and Exchange Act Rules 12b-20[7] and 13a-1.[8] As part of the injunctive action, Andersen also was required to pay disgorgement, prejudgment interest and a civil money penalty of $126,219.[9]

According to the OIP, the Commission's complaint in the injunctive action alleged that Andersen performed audits in 1999 and 2000, for Hardrock Mines, Inc. (later known as Exotics.com, Inc.), which were not conducted in accordance with generally accepted auditing standards and caused his auditing firm to issue audit reports falsely stating that the financial statements were presented in conformity with generally accepted accounting principles. These reports, it was alleged, were incorporated into public filings made by Hardrock Mines. The injunctive complaint further alleged that Andersen had not acted as an independent auditor because he himself had prepared most of the client's books and records and financial statements.

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2 *L. Rex Andersen, CPA*, Securities Exchange Act Rel. No. 62262 (Jun. 10, 2010), __ SEC Docket __.

3 17 C.F.R. § 201.102(e)(3)(ii).

4 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5 prohibit fraud in connection with securities transactions.

5 17 C.F.R. § 210.2-02 sets out the requirements for accountants' audit reports and attestation reports.

6 15 U.S.C. § 78m(a) sets out periodic filing and recordkeeping requirements for issuers registered under the Exchange Act.

7 17 C.F.R. § 240.12b-20 mandates that, "[i]n addition to the information expressly required to be included in a statement or report [required by the Commission], there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."

8 17 C.F.R. § 240.13a-1 establishes annual filing requirements for registered issuers.

9 *SEC v. Exotics.com, Inc.*, Civ. Act. No. 2:05-cv-00531-PMP-GWF (D. Nev. May 4, 2010).

Moreover, the complaint alleged, Andersen created the client's books and records in reliance on documents that he knew, or was reckless in not knowing, were fraudulent.

II.

In issuing the OIP, we found that it was "appropriate and in the public interest that Andersen be temporarily suspended from appearing or practicing before the Commission," based on the injunctive order. We stated that the temporary suspension would become permanent unless Andersen filed a petition challenging it within thirty days of service of the order, pursuant to Rule of Practice 102(e)(3)(ii). We further advised that, pursuant to Rule of Practice 102(e)(3)(iii), upon receipt of such a petition, we would either lift the temporary suspension, set the matter down for hearing, or both.

In his petition, Andersen does not explicitly request that the temporary suspension be lifted. His petition does, however, seem to challenge the factual basis for the injunctive order and, implicitly, the temporary suspension. For example, he asserts that "it cannot be shown that I had a motive and opportunity to mislead nor has the SEC shown any specific instances of my intent to mislead." Anderson also states that he "was not aware of any public trading of the company stock during the time of my service" and claims that "the Company attorney . . . assured [him] that the documents [Andersen relied upon] were valid."

"Rule 102(e)(3) permits the Commission to suspend any accountant or other professional or expert who has been permanently enjoined from violating or aiding and abetting the violation of the Federal securities laws . . . ."[10] Generally, a respondent in a "follow-on" proceeding is precluded from challenging the basis for, or findings in, the underlying injunctive action.[11] At this stage, it appears that the allegations made in the injunctive proceeding "justify the continuance of his suspension until it can be determined what, if any, action may be appropriate to protect the Commission's process."[12] As provided in Rule 102(e)(3)(iii), therefore, we will set the matter down for public hearing.

Accordingly, IT IS ORDERED that this proceeding be set down for public hearing before an administrative law judge in accordance with Rule of Practice 110. As specified in Rule of

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10 *Daniel S. Lezak*, 57 S.E.C. 997, 1001 (2004).

11 *Michael Batterman*, 57 S.E.C. 1031, 1039 n.18 (2004); s*ee also Lezak*, 57 S.E.C. at 1001 (holding that "[t]he findings of the Court, which [the petitioner] is precluded from contesting in this proceeding, as well as the injunction issued against him justify the continuance of his suspension until it can be determined what, if any, action may be appropriate to protect this Commission's processes").

12 *William D. Shovers*, Exchange Act Rel. No. 59874 (May 6, 2009), 95 SEC Docket 16512, 16515.

Practice 102(e)(3)(iii), the hearing in this matter shall be expedited in accordance with Rule of Practice 500; it is further

ORDERED that the administrative law judge shall issue an initial decision no later than 210 days from the date of service of this Order; and it is further

ORDERED that the temporary suspension of L. Rex Andersen, entered on June 10, 2010, remain in effect pending a hearing and decision in this matter.

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. 62497/ July 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13967

In the Matter of **THE COLONIAL BANCGROUP, 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 The Colonial BancGroup, Inc. ("Colonial BancGroup" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

A. Colonial BancGroup (CIK No. 0000092339) is a Delaware corporation based in Montgomery, Alabama. Colonial BancGroup's common stock is registered with the Commission pursuant to Exchange Act Section 12(g) and is quoted on the "Pink Sheets" operated by Pink OTC Markets, Inc. under the symbol "CBCGQ" or "CBCGQ.PK." Colonial BancGroup is required to file reports pursuant to Section 13(a) of the Exchange Act.

B. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in current and periodic reports, even if the registration under Section 12(g) is voluntary. Specifically, Rule 13a-1 requires issuers to file annual reports (Forms 10-K or 10-KSB), Rule 13a-11 requires issuers to file current reports (Form 8-K), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

C. Colonial BancGroup is delinquent in its periodic filings with the Commission.

D. Colonial BancGroup has not filed an annual report on either Form 10-K or Form 10-KSB since March 2, 2009.

E. Colonial BancGroup has been aware since on or about August 2009 that its previously issued financial statements, covering one or more years or interim periods for which Colonial BancGroup is required to provide financial statements under Regulation S-X [17 C.F.R. § 210], should no longer be relied upon because of an error in such financial statements. Colonial BancGroup has not filed an Item 4.02 Form 8-K disclosing a non-reliance on previously issued financial statements and has therefore not filed all required Forms 8-K.

F. Colonial BancGroup has not filed quarterly reports on either Form 10-Q or Form 10-QSB since May 8, 2009.

G. As a result of the foregoing, Colonial BancGroup has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 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 pursuant to Section 12(j) of the Exchange Act to determine:

A. Whether the allegations 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 of the Respondent identified in Section II hereof 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, as provided by Rule 200 of the Commission's Rules of Practice [17 C.F.R. § 201.200], and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS FURTHER ORDERED that the Respondent shall file an Answer to the allegations contained in this Order Instituting Proceedings within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice [17 C.F.R. § 201.220]. If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against the Respondent upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310].

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

Elizabeth M. Murphy
Secretary

OFFICE OF GOVERNMENT ETHICS

SECURITIES AND EXCHANGE COMMISSION

5 CFR Part 4401 and 17 CFR Part 200

Release No. 34-62501

Adoption of Supplemental Standards of Ethical Conduct for Members and Employees of the Securities and Exchange Commission and Revisions to the Commission's Ethics Rules

AGENCIES: Office of Government Ethics and Securities and Exchange Commission.

ACTION: Final Rule.

SUMMARY: The Securities and Exchange Commission with the concurrence of the Office of Government Ethics is adopting supplemental standards of ethical conduct for the Commission's members and employees. The new supplemental standards give guidance to Commission members and employees on permitted, prohibited, and restricted financial interests and transactions and on engaging in outside employment and activities. In addition, the Commission has revised its ethics rules to make them compatible with the Office of Government Ethics' government-wide ethics provisions and to reflect current Commission policies.

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

FOR FURTHER INFORMATION CONTACT: Richard E. Connor, Office of the General Counsel, (202) 551-5170, Securities and Exchange Commission, 100 F Street N.E., Washington, DC 20549-1050.

I. Supplementary Information:

The Securities and Exchange Commission with the concurrence of the Office of Government Ethics ("OGE") is adopting supplemental standards of ethical conduct for the Commission's members and employees. The Commission first adopted conduct regulations in 1953 "to restate the ethical principles which it believes should govern and have governed the conduct of members and employees and former members and employees." Subsequent comprehensive revisions in 1966 and 1980 were enacted to provide members, employees, special government employees, and former Commission members and employees with a comprehensive statement of standards of conduct which are dictated by applicable Federal law, Executive Orders, and the Commission's own requirements.[5]

Executive Order 12674, as amended by Executive Order 12731, authorized OGE to establish a single, comprehensive, and clear set of executive-branch standards of conduct. On August 7, 1992, OGE published the Standards of ethical conduct for employees of the executive branch, codified at 5 CFR part 2635, to establish uniform standards of ethical conduct for all executive branch employees.[6] With the concurrence of OGE, 5 CFR § 2635.105 authorizes executive branch agencies to publish agency-specific supplemental regulations necessary to implement their respective ethics programs.

The Commission has responsibility for oversight of the securities industry and the protection of investors. These new supplemental standards are necessary to re-codify and provide guidance to Commission members and employees on permitted, prohibited, and

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[5] See, e.g., 45 FR 36064 (May 29, 1980).

[6] See 57 FR 35006-35067 (Aug. 7, 1992), as corrected at 57 FR 48557 (Oct. 27, 1992) and 57 FR 52583 (Nov. 4, 1992), with additional grace period extensions at 59 FR 4779-4780 (Feb. 2, 1994), 60 FR 6390-6391 (Feb. 2, 1995), 60 FR 66857-66858 (Dec. 27, 1995) and 61 FR 40950-40952 (Aug. 7, 1996).

restricted financial interests and transactions and on engaging in outside employment and activities. The Commission is also updating its existing ethics rules to conform to OGE's government-wide ethics obligations and reflect current Commission policies.

A. The Commission's supplemental standards are contained in new 5 CFR part 4401. New Rule 4401.101 (General) states that Commission members and employees must comply with 5 CFR part 2635 (Standards of ethical conduct for employees of the executive branch). New Rule 4401.101 further states that members and employees are subject to the Executive branch financial disclosure regulations, 5 CFR part 2634; the Office of Personnel Management's Employee responsibilities and conduct regulations at 5 CFR part 735; and 17 CFR part 200, subparts C and M, as amended, the Commission's Canons of ethics and the Regulation concerning conduct of members and employees and former members and employees.

New Rule 4401.102 (Prohibited and restricted financial interests and transactions) supersedes former Commission ethics rule 735-5 (Securities transactions). New Rule 4401.102(a) provides that the rule's provisions apply to all securities holdings or transactions effected directly or indirectly on behalf of the member or employee. The rule's requirements also extend to holdings and transactions of or on behalf of the member's or employee's spouse, unemancipated minor children, or persons for whom the member or employee serves as legal guardian.

New Rule 4401.102(b)(1) prohibits members and employees from purchasing or selling a security while in possession of material nonpublic information, as defined in 5 CFR § 2635.703(b). Rule 2635.703(b) states that nonpublic information is information that the individual gains through his or her Federal position, which the person knows or reasonably should know is not available to the general public. Under this definition, nonpublic information includes information routinely exempt from disclosure under the Freedom of Information Act, 5 U.S.C. § 552 or otherwise protected by statute, rule, or Executive Order; information that the Commission designates as confidential; and information that is not generally available to the public and that the Commission has not actually released or disseminated.[7]

New Rule 4401.102(b)(2) prohibits members or employees from recommending or suggesting the purchase or sale of a security either based on material nonpublic information about the security or which the member or employee cannot purchase or sell because of this rule's restrictions.

New Rule 4401.102(c) states that members and employees may not -

- Knowingly purchase or hold a security or other financial interest in an entity directly regulated by the Commission;

- Purchase a security in an initial public offering ("IPO") for seven calendar days after the IPO is effective, except for IPOs of shares in a registered investment company or other publicly traded or publicly available collective investment fund;

- Purchase or carry securities on margin;

- Sell securities short;[8]

- Enter into a financial relationship or obtain a loan from an entity or person directly regulated by the Commission and receive terms more favorable than would be

[7] Prohibitions regarding disclosure or use of confidential or nonpublic information are set forth in Clause 30 of Schedule A of the Securities Act of 1933, 15 U.S.C. 77aa(30) and Securities Act Rules 122 and 406 (17 CFR 230.122, 230.406); sections 13(f)(3) and 24(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(f)(3), 78x) and Exchange Act Rule 0-4 (17 CFR 240.24b-2); section 45(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-44) and Investment Company Act Rule 45a-1 (17 CFR 270.45a-1); and section 210(b) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-10).

[8] Short selling is defined in 17 CFR § 242.200(a).

available in like circumstances to members of the public, except as otherwise permitted by 5 CFR 2635, subpart B (Gifts from outside sources);

- Engage in any transactions involving derivatives, except for transactions in shares in a registered investment company or other publicly traded or publicly available collective investment fund; or

- Purchase or sell any security of an entity that is under investigation by the Commission, a party to a proceeding before the Commission, or a party to a proceeding in which the Commission is a party.

New Rule 4401.102(d)(1) generally requires members and employees to clear any securities or related financial transaction. Currently, the Commission is clearing transactions through the Ethics Program System ("EPS") computer system. New Rule 4401.102(d)(2) provides that, if the member or employee obtains clearance of the transaction as provided in the rule, that clearance will be prima facie evidence that the member or employee did not knowingly purchase, sell, or hold a security of a regulated entity; improperly purchase an IPO or engage in a transaction in a derivative; or improperly purchase or sell a security of an entity subject to Commission investigation or enforcement action.

New Rule 4401.102(e) provides generally that members and employees must hold a security for a minimum of six months from the trade date.[9] Under new Rule 4401.102(e)(2), the holding period does not apply to securities that are sold for 90 percent or less of their original purchase price; securities with an initial term of less than six months that are held to term; or shares in money market funds. New Rule

[9] This rule applies to securities purchased after Commission employment.

4401.102(e)(3) requires members and employees to hold shares of registered investment companies for a minimum of 30 days from the purchase date.

New Rule 4401.102(f)(1) generally requires members and employees to report all securities holdings as required by the Designated Agency Ethics Official ("DAEO"). Currently, this reporting occurs through EPS. Also, members and employees must provide duplicate statements for every account containing reportable securities to the DAEO. Under new Rule 4401.102(f)(2) members and employees must report all purchases and sales within five days of receipt of confirmation of the transaction.[10] The reporting of purchases and sales is also done through EPS.

Consistent with current Commission standards, new Rule 4401.102(g)(1) excludes certain transactions and holdings from the rule's requirements. Certain holdings and transactions are excluded from the prohibition of new Rule 4401.102(c) and the prior clearance, holding period, and reporting requirements. These include:

-Transactions effected by the member's or employee's spouse on behalf of someone other than the member or employee, the spouse, their unemancipated minor child, or a person for whom the member or employee serves as legal guardian;

- Holdings or transactions effected by a member's or employee's legally separated spouse living apart from the member or employee (even if for their unemnacipated minor child) so long as the member or employee does not in fact control, advise with respect to, or have knowledge of these holdings and transactions;

- U.S. Government or Federal government agency securities;

[10] Any person who receives a conditional offer of employment from the Commission must report all securities holdings after acceptance of that offer and before commencement of employment with the Commission on the prescribed form. These reports are currently received on SEC Form 682.

- Investments in the Thrift Savings Plan or a government retirement plan administered by a Federal agency; and

- Certificates of deposit and comparable instruments issued by depository institutions subject to federal regulation and federal deposit insurance.

In accordance with existing standards, new Rule 4401.102(g)(2) provides that certain additional transactions are not prohibited by new Rule 4401.102(c) and excludes these holdings and transactions from the prior clearance and holding requirements. However, these interests must be reported in accordance with new Rule 4401.102(f). This exclusion applies to:

- the holdings of a trust in which the member or employee (or the member's or employee's spouse, the member's or employee's unemancipated minor child, or person for whom the member or employee serves as legal guardian) is (i) solely a vested beneficiary of an irrevocable trust or (ii) solely a vested beneficiary of a revocable trust where the trust instrument expressly directs the trustee to make present, mandatory distributions of trust income or principal; provided, that the member or employee did not create the trust, has no power to control, and does not, in fact, control or advise with respect to the holdings and transactions of the trust or have knowledge of its holdings or transactions;

- the acceptance or reinvestment of stock dividends on securities already owned;

- the exercise of a right to convert securities; and

- the acquisition of stock or the acquisition or exercise of employee stock options or similar instruments received as compensation and issued by either (i) a member's or employee's former employer or (ii) the present or former employer of the member's or employee's spouse.

New Rule 4401.102(h) sets forth the circumstances under which members and employees may seek a waiver of the requirements of the rule.

New Rule 4401.103 supersedes in part Commission rule 735-4, 17 CFR § 200.735-4 (Outside employment and activities) and sets forth the circumstances under which Commission members, employees, and special government employees may engage in outside employment or activities. New Rule 4401.103(a)(2) broadly defines employment to include any form of non-Federal employment or business relationship, involving the provision of personal service by the employee. The definition includes acting as an officer, director, employee, agent, attorney, consultant, contractor, general partner, trustee, teacher, writer, or speaker. The rule excludes participation in certain nonprofit religious, charitable, and civic organizations from the definition of employment unless the person (i) serves as an officer or director; (ii) provides professional services or advice; (iii) receives compensation (other than reimbursement for expenses) from the organization; or (iv) is an active participant as defined in 5 CFR § 2635.502(b)(1)(v) on a committee of a professional organization whose interests may be substantially affected by the Commission.

New Rule 4401.103(b) encourages members and employees to participate in *pro bono* and community service so long as that service is consistent with OGE's requirements including 5 CFR parts 2634 (governing financial reporting) and 2635 (establishing the government-wide ethics standards), as well as the restrictions contained in 18 U.S.C. §§ 203 (prohibiting seeking or receiving compensation for representational services before the Government), 205 (prohibiting assisting in prosecution of claims against or acting as attorney or agent before the Government), and 208 (prohibiting an employee's participation in matters affecting the employee's own financial interest and those of certain specified persons and organizations).

Under new Rule 4401.103(d)(1), each employee must obtain prior approval before engaging in any outside employment, whether or not for compensation. New Rule 4401.103(c)(1)(i) provides that no employee may engage in any outside employment or activity that conflicts with Commission employment. New Rule 4401.103(c)(1)(iii) prohibits any employee from (i) outside employment on behalf of any entity regulated by the Commission; (ii) engaging in activity directly or indirectly related to the issuance, purchase, investment, or trading of securities or securities futures, except for securities holdings or transactions permitted by new Rule 4401.102; or (iii) engaging in work otherwise involved with the securities industry. Commission members are subject to the restrictions of Section 4(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78d(a).

Under new Rule 4401.103(d)(2), an employee's request for prior approval of any outside employment must be made both to the appropriate Division Directors, Office Heads, or Regional Directors as well as the Commission's Office of the General Counsel's Ethics Office. New Rule 4401.103(d)(3) requires that the request identify the proposed outside employer; describe the work to be performed, the duration of the employment, and any compensation to be received; and include a statement that the employee will disqualify himself or herself from matters involving the proposed employer.

Under new Rule 4401.103(d)(4), the request must be updated annually or if there is a significant change in either the nature of the employment or in the employee's position with the Commission. New Rule 4401.103(d)(5) provides that approval will be granted only if the outside employment does not involve conduct prohibited by law or regulation, including the government-wide ethics requirements in 5 CFR part 2635.

B. The Commission is separately amending its Regulation concerning conduct of Commission members and employees and former members and employees, 17 CFR 200-735-1 *et seq*. These amendments generally delete Commission requirements that are duplicative of OGE's government-wide requirements. The amendments also direct members, employees, special government employees, and former members and employees to the applicable ethics laws and regulations for ease of reference.

Certain Commission ethics requirements remain in effect. Under 17 CFR § 200.735-3(b) (General provisions), a member or employee shall not engage in any personal business transaction or arrangement for personal profit which arises from his or her official position or authority or is based on nonpublic information obtained by virtue of that position or authority. The restrictions on release of nonpublic Commission documents contained in 17 CFR § 200.735-3(b)(2) (Policy) (formerly Rule 735-3(b)(7)) also remain in effect. The Commission encourages its members and employees to engage in teaching, lecturing, and writing. Therefore, the provisions governing those activities, including the clearance of publications and speeches, contained in 17 CFR § 200.735-4(b) and (d) (formerly Rules 735-4 (b)(5) and (e)), continue.

The Commission will also continue to require any former member or employee who is retained or employed to represent any person before the Commission within two years of leaving the Commission to provide written notice of that representation. 17 CFR § 200.735-8(b) (Practice by former members and employees of the Commission).

The amendments also replace references to the Director of Personnel with references to the General Counsel, the Commission's Office of the General Counsel's Ethics Office, and the Designated Agency Ethics Official to reflect current agency practice.

II. Administrative Procedure Act, Regulatory Flexibility Act, and Paperwork Reduction Act

The Commission finds, in accordance with section 553(b)(3)(A) of the Administrative Procedure Act,[11] that these rules relate solely to agency organization, procedure, or practice. These rules are therefore not subject to the provisions of the Administrative Procedure Act requiring notice, opportunity for public comment, and publication. The Regulatory Flexibility Act [12] therefore does not apply. Because these rules relate to "agency organization, procedure or practice that does not substantially affect the right or obligations of non-agency parties," they are not subject to the Small Business Regulatory Enforcement Fairness Act.[13] The rules do not contain any new collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended.[14]

III. Costs and Benefits of the Amendments

Taken as a whole, the Commission and the public have a substantial interest in the integrity of the Commission's processes. Congress has directed the Commission to oversee the securities markets and securities professionals and to protect investors. To

[11] 5 U.S.C. 553(b)(3)(A).
[12] 5 U.S.C. 601 *et seq.*
[13] 5 U.S.C. 804(3)(C).
[14] 44 U.S.C. 3501 *et seq.*

that end, the ethical standards contained in the rules enacted today require the Commission's members and employees to maintain high standards of honesty, integrity, and impartiality, and to avoid actual, or the appearance of, conflicts of interest.

In general, the costs of the procedures in the Commission's rules of practice fall largely on the Commission and its employees. As noted, the amendments set forth in this release relate to internal agency management. These rules re-codify pre-existing obligations on the Commission's members and employees with certain minor modifications. As such, the Commission believes that the costs imposed by compliance with these amended rules have not substantially increased from the obligations of Commission members and employees before these amendments.

IV. Consideration of Burden on Competition

Section 23(a)(2) of the Exchange Act, 15 U.S.C. § 78w(a)(2), requires the Commission, in making rules pursuant to any provision of the Exchange Act, to consider among other matters the impact any such rule would have on competition. The purposes of the Exchange Act include protection of interstate commerce and maintenance of fair and honest markets. The degree of trust that investors and the public have in the Commission and its employees is critical to these goals. The Commission and its employees must adhere to the highest standards of integrity and impartiality and avoid the appearance of conflicts of interest. These rules affect a relatively small number of persons. Therefore, the Commission has determined that the burden on competition is small and is necessary and appropriate in furtherance of the purposes of the Exchange Act.

Section 2(b) of the Securities Act, 15 U.S.C. § 77b(b); Section 3(f) of the Exchange Act, 15 U.S.C. § 78c(f); Section 2(c) of the Investment Company Act of 1940, 15 U.S.C. § 80a-2(c); and Section 202(c) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(c) require that the Commission consider efficiency, competition, and capital formation, in addition to the protection of investors, whenever it is required to consider or determine whether an action is necessary or appropriate in the public interest. As noted above, these rules apply to a relatively small number of people and do not substantially alter their pre-existing obligations. The Commission believes that the amendments that the Commission is adopting today will have a small impact on competition, the capital markets, or capital formation.

V. Statutory Basis for the Rules

These new supplemental rules and the amendments to the Commission's ethics rules are being adopted pursuant to statutory authority granted to OGE and to the Commission. These include 5 U.S.C. § 7301; 5 U.S.C. App. (Ethics in Government Act of 1978); section 19 of the Securities Act of 1933, 15 U.S.C. § 77s; section 23 of the Securities Exchange Act of 1934, 15 U.S.C. § 78w; section 319 of the Trust Indenture Act of 1939, 15 U.S.C. § 77sss; section 40 of the Investment Company Act of 1940, 15 U.S.C. § 80a-39; and section 211 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-11.

List of Subjects

5 CFR Part 4401

Supplemental Standards of Ethical Conduct for Members and Employees of the Securities and Exchange Commission

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government Agencies)

Organization; Conduct and Ethics; and Information and Requests

TITLE 5–[AMENDED]

For the reasons set out in the preamble, Title 5 of the Code of Federal Regulations is amended as follows:

1. Add a new chapter XXXIV, consisting of part 4401 to read as follows:

CHAPTER XXXIV – SECURITIES AND EXCHANGE COMMISSION

PART 4401 – SUPPLEMENTAL STANDARDS OF ETHICAL CONDUCT FOR MEMBERS AND EMPLOYEES OF THE SECURITIES AND EXCHANGE COMMISSION

Authority: 5 U.S.C. 7301; 5 U.S.C. App. (Ethics in Government Act of 1978); E.O. 12674, 54 FR 15159; 3 CFR 1989 Comp., p. 215, as modified by E.O. 12731, 55 FR 42547; 3 CFR, 1990 Comp., p. 306; 5 CFR 2635.105, 2635.403, 2635.803; 15 U.S.C. 77s, 78w, 77sss, 80a-37, 80b-11.

§4401.101 General.

In accordance with 5 CFR 2635.105, the regulations in this part apply to members and employees of the Securities and Exchange Commission ("Commission") and supplement the Standards of ethical conduct for employees of the executive branch contained in 5 CFR 2635. Members and employees of the Commission are required to comply with 5 CFR 2635 and this part. In addition, they are subject to the Executive branch financial disclosure regulations, 5 CFR 2634; the Office of Personnel Management Employee responsibilities and conduct regulations at 5 CFR 735; and the Commission's Canons of ethics and Regulation concerning conduct of members and employees and former members and employees, 17 CFR 200, subparts C and M as amended.

§ 4401.102 Prohibited and restricted financial interests and transactions.

(a) Applicability. The requirements of this § 4401.102 apply to all securities holdings or transactions effected, directly or indirectly, by or on behalf of a member or employee, the member's or employee's spouse, the member's or employee's unemancipated minor child, or any person for whom the member or employee serves as legal guardian. A member or employee is deemed to have sufficient interest in the securities holdings and transactions of his or her spouse, unemancipated minor child, or person for whom the member or employee serves as legal guardian that such holdings or transactions are subject to all the terms of this Rule.

(b) In General.

(1) Members and employees are prohibited from purchasing or selling any security while in possession of material nonpublic information regarding that security. Nonpublic information has the meaning as provided in 5 CFR 2635.703(b).

(2) Members and employees are prohibited from recommending or suggesting to any person the purchase or sale of security:

(i) based on material nonpublic information regarding that security; or

(ii) that the member or employee could not purchase or sell because of the restrictions contained in this Rule.

(c) Prohibited and restricted holdings and transactions. Members and employees are prohibited from:

(1) Knowingly purchasing or holding a security or other financial interest in an entity directly regulated by the Commission;

(2) Purchasing a security in an initial public offering ("IPO") for seven calendar days after the IPO effective date, except that this prohibition does not apply to an IPO of shares in a registered investment company or other publicly traded or publicly available collective investment fund;

(3) Purchasing or otherwise carrying securities on margin;

(4) Selling securities short as defined in 17 CFR 242.200(a);

(5) Accepting a loan from, or entering into any other financial relationship with, an entity, institution or other person directly regulated by the Commission if the loan or financial relationship is governed by terms more favorable than would be available in like circumstances to members of the public, except as otherwise permitted by 5 CFR 2635, subpart B (Gifts from outside sources);

(6) Engaging in transactions involving financial instruments that are derivatives of securities (that is, the value of the security depends on or is derived from, in whole or in part, the value of another security, or a group, or an index of securities), except that this prohibition does not apply to transactions in shares in a registered investment company or other publicly traded or publicly available collective investment fund; and

(7) Purchasing or selling any security issued by an entity that is:

(i) under investigation by the Commission;

(ii) a party to a proceeding before the Commission; or

(iii) a party to a proceeding to which the Commission is a party.

(d) <u>Prior clearance of transactions in securities or related financial interests</u>.

(1) Except as set forth in this § 4401.102(g), members and employees must confirm before entering into any security or other related financial transaction that the security or related financial transaction is not prohibited or restricted as to them by clearing the transaction in the manner required by the Designated Agency Ethics Official ("DAEO"). A member or employee will have five business days after clearance to effect a transaction.

(2) Documentation of the clearance of any transaction pursuant to this § 4401.102(d) shall be prima facie evidence that the member or employee has not knowingly purchased, sold, or held such financial interest in violation of the provisions of these § 4401.102(c)(1), (2), (6), or (7).

(3) The DAEO shall be responsible for administering the Commission's clearance systems. The DAEO shall maintain a record of securities that members and

employees may not purchase or sell, or otherwise hold, because such securities are the subject of the various prohibitions and restrictions contained in this § 4401.102.

(e) Holding periods for securities and related financial interests.

(1) General Rule. Except as set forth in this § 4401.102(g) and in paragraphs (2) and (3) of this paragraph (e), members and employees must hold a security purchased after commencement of employment with the Commission for a minimum of six (6) months from the trade date.

(2) General exceptions. This holding period does not apply to:

(i) Securities sold for ninety percent (90) or less of the original purchase price;

(ii) Securities with an initial term of less than six (6) months that are held to term; and

(iii) Shares in money market funds, as defined in Rule 12d1-1(d)(2), 17 CFR 270.12d1-1(d)(2).

(3) Exception for shares in registered investment companies. Members and employees must hold shares in registered investment companies for a minimum of thirty (30) days from the purchase date.

(f) Reporting requirements.

(1) Except as set forth in this § 4401.102(g), members and employees must:

(i) report and certify all securities holdings according to the schedule required by the DAEO; and

(ii) submit duplicate statements for every account containing reportable securities to the DAEO according to such procedures required by the DAEO.

(2) Members and employees must report all purchases, sales, acquisitions, or dispositions of securities within five (5) business days after receipt of confirmation of the transaction.

(3) Any person who receives a conditional offer of employment from the Commission must report all securities holdings after acceptance of that offer and before commencement of employment with the Commission on the form prescribed by the Commission.

(g) Exceptions.

(1) The following transactions are exempt from the requirements of this § 4401.201(c), (d), (e), and (f):

(i) Securities transactions effected by a member's or employee's spouse on behalf of an entity or person other than the member or employee, the member's or employee's spouse, the member's or employee's unemancipated minor child, or any person for whom the member or employee serves as legal guardian;

(ii) Securities holdings and transactions of a member's or employee's legally separated spouse living apart from the member or employee (including those effected for the benefit of the member's or employee's minor child), *provided that* the member or employee has no control, and does not, in fact, control, advise with respect to, or have knowledge of those holdings and transactions;

(iii) Securities issued by the United States Government or one of its agencies;

(iv) Investments in funds administered by the Thrift Savings Plan or by any retirement plan administered by a Federal government agency; and

(v) Certificates of deposit or other comparable instruments issued by depository institutions subject to federal regulation and federal deposit insurance.

(2) The following holdings and transactions are exempt from the requirements of this § 4401.102(c), (d), and (e), but these interests must be reported in accordance with this § 4401.102(f):

(i) The holdings of a trust in which the member or employee (or the member's or employee's spouse, the member's or employee's unemancipated minor child, or person for whom the member or employee serves as legal guardian) is:

(A) solely a vested beneficiary of an irrevocable trust; or

(B) solely a vested beneficiary of a revocable trust where the trust instrument expressly directs the trustee to make present, mandatory distributions of trust income or principal; provided, the member or employee did not create the trust, has no power to control, and does not, in fact, control or advise with respect to the holdings and transactions of the trust;

(ii) Acceptance or reinvestment of stock dividends on securities already owned;

(iii) Exercise of a right to convert securities; and

(iv) The acquisition of stock or the acquisition or the exercise of employee stock options, or other comparable instruments, received as compensation from an issuer that is:

(A) the member's or employee's former employer; or

(B) the present or former employer of the member's or employee's spouse.

(h) Waivers.

(1) Members may request from the Commission a waiver of the prohibitions or limitations that would otherwise apply to a securities holding or transaction on the grounds that application of the rule would cause an undue hardship. A member requests a waiver by submitting a confidential written application to the Commission's Office of the General Counsel's Ethics Office. The DAEO will review the request and provide to the Commission a recommendation for resolution of the waiver request. In developing a recommendation, the DAEO may consult, on a confidential basis, other Commission personnel as the DAEO in his or her discretion considers necessary.

(2) Employees may request from the DAEO a waiver of the prohibitions or limitations that would otherwise apply to a securities holding or transaction on the grounds that application of the rule would cause an undue hardship. An employee requests a waiver by submitting a confidential written application to the Commission's Office of the General Counsel's Ethics Office in the manner prescribed by the DAEO. In considering a waiver request, the DAEO, or his or her designee, may consult with the employee's supervisors and other Commission personnel as the DAEO in his or her discretion considers necessary.

(3) The Commission or the DAEO, as applicable, will provide written notice of its determination of the waiver request to the requesting member or employee.

(4) The Commission or the DAEO, as applicable, may condition the grant of a waiver under this provision upon the agreement to certain undertakings (such as execution of a written statement of disqualification) to avoid the appearance of misuse of position or loss of impartiality, and to ensure confidence in the impartiality and objectivity of the Commission. The Commission or DAEO, as applicable, shall note the

existence of conditions on the waiver and describe them in reasonable detail in the text of the waiver-request determination.

(5) The grant of a waiver requested pursuant to this section must reflect the judgment that the waiver:

(i) is necessary to avoid an undue hardship; and, under the particular circumstances, application of the prohibition or restriction is not necessary to avoid the appearance of misuse of position or loss of impartiality, or otherwise necessary to ensure confidence in the impartiality and objectivity of the Commission;

(ii) is consistent with 18 U.S.C. 208 (Acts affecting a personal financial interest), 5 CFR 2635 (Standards of ethical conduct for employees of the executive branch), and 5 CFR 2640 (Interpretation, exemptions and waiver guidance concerning 18 U.S.C. 208); and

(iii) is not otherwise prohibited by law.

(6) The determination of the Commission with respect to a member's request for a waiver is final and binding on the member.

(7) The determination of the DAEO with respect to an employee's request for a waiver may be appealed to the Commission, in accordance with the requirements of Rules 430 and 431 of the Commission's Rule of Practice, 17 CFR 201.430, 201.431. The determination of the DAEO or, if appealed, the Commission, is final and binding on the employee.

(8) Notwithstanding the grant of a waiver, a member or employee remains subject to the disqualification requirements of 5 CFR 2635.402 (Disqualifying financial

interests) and 5 CFR 2635.502 (Personal and business relationships) with respect to transactions or holdings subject to the waiver.

(i) Required Disposition of Securities. The DAEO is authorized to require disposition of securities acquired as a result of a violation of the provisions of this section, whether unintentional or not. The DAEO shall report repeated violations to the Commission for appropriate action.

§ 4401.103 Outside employment and activities.

(a) Definitions.

As used in this section:

(1) Employee is defined in 5 CFR 2635.102(h) and includes employees and special government employees of the Commission.

(2) Employment is defined broadly, as any form of non-Federal employment or business relationship, involving the provision of personal services by the employee. It includes services as an officer, director, employee, agent, attorney, accountant, consultant, contractor, general partner, trustee, teacher, writer, or speaker, but does not include participation in the activities of a nonprofit charitable, religious, professional, civic, or public service organization, unless such activities:

(i) involve serving as an officer or director of the organization;

(ii) involve providing professional services or advice to the organization;

(iii) are for compensation, other than reimbursement of expenses; or

(iv) involve serving as an active participant (as defined in 5 CFR 2635.502(b)(1)(v)) in a professional organization whose interests may be substantially affected by the Commission.

(3) Professional services means practicing a profession as the term "profession" is defined in 5 CFR 2636.305(b)(1).

(4) DAEO is the Designated Agency Ethics Official.

(b) Pro bono and community service. Subject to the prohibitions, restrictions and requirements contained in law and federal regulations, including 18 U.S.C. 203 (Compensation to members of Congress, officers, and others in matters affecting the Government), 205 (Activities of officers and employees in claims against and other matters affecting the Government), and 208 (Acts affecting a personal financial interest), 5 CFR 2634 (Executive branch financial disclosure), 5 CFR 2635 (Standards of ethical conduct for employees of the executive branch), and paragraph (c) of this section, employees are encouraged to participate in matters involving improvement to their communities, and, when qualified, to provide professional *pro bono* services.

(c) Prohibitions and restrictions on outside employment and activities.

(1) Prohibitions and restrictions on employees other than members.

(i) No employee may engage in any outside employment or activities that conflict with employment with the Commission.

(ii) No employee shall engage in any outside employment, whether or not for compensation, without prior approval, in accordance with paragraph (d), below.

(iii) The Commission will not approve the following kinds of employment or activities:

(A) employment with any entity regulated by the Commission;

(B) employment or any activity directly or indirectly related to the issuance, purchase, sale, investment or trading of securities or futures on securities or a group of securities, except this prohibition does not apply to securities holdings or transactions permitted by § 4401.102 of this subpart; or

(C) employment otherwise involved with the securities industry.

(2) Prohibitions and restrictions on members.

(i) Members of the Commission may engage in outside employment only to the extent permitted by Section 4(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78d(a). This provision does not preclude members from engaging in permitted securities transactions.

(ii) Notwithstanding the absence of a statutory prohibition, a member may not engage in any outside employment or activity, if such outside employment or activity would materially impair the member's ability to perform properly the member's duties. Such outside employment or activity includes such fiduciary relationships such as serving as a trustee, executor or corporate director.

(d) Prior approval requirement.

(1) An employee, other than a member or special government employee, must obtain written approval before engaging in any outside employment (whether or not for compensation).

(2) Requests for prior approval of outside employment shall be submitted in writing to the appropriate agency designee and to the Commission's Office of the General Counsel's Ethics Office. Agency designees include Division Directors, Office Heads and Regional Directors.

(3) The request shall include, at a minimum:

(i) the name and address of the prospective outside employer;

(ii) a description of the proposed outside employment, including the duties and services to be performed;

(iii) the expected duration of the outside employment;

(iv) the fee or other compensation, if any, to be received by the Commission employee for the outside employment; and

(v) a statement that the employee will disqualify himself or herself, if the request is approved, from participating in particular matters that could directly affect his outside employer during the period of the outside employment and, thereafter, from participating in particular matters involving specific parties, consistent with 5 CFR 2635.502 (Personal and business relationships).

(4) The employee shall submit an updated request for approval:

(i) annually;

(ii) upon a significant change in the nature or scope of the outside employment; or

(iii) upon a significant change in the employee's official position at the Commission.

(5) Approval shall be granted only upon a determination by both the agency designee and Designated Agency Ethics Officers ("DAEO") or by the Commission, on appeal, pursuant to paragraph (d)(6) of this section, that the outside employment is not expected to involve conduct prohibited by law or federal regulation, including 5 CFR 2635 (Standards of ethical conduct for employees of the executive branch), and this part.

(6) An employee may appeal the disapproval of a request to engage in outside employment by the agency designee or by the Commission's Office of the General

Counsel's Ethics Office to the Commission in accordance with the requirements of Commission Rules 430 and 431 of the Commission's Rules of Practice, 17 CFR 201.430, 201.431. That appeal shall be submitted in writing to the Commission through the Commission's Office of the General Counsel's Ethics Office and shall explain why the employee believes that his or her request should be approved.

(e) Employees are required to submit proposed publications or prepared speeches relating to the Commission, or the statutes or rules it administers, to the Commission's Office of the General Counsel's Ethics Office for review, pursuant to the Commission's Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission, 17 CFR 200.735-4 (Outside Employment and Activities). Any such publication or speech must include the disclaimer prescribed in 17 CFR 200.735-4(c)(ii). Employees who wish to engage in teaching, writing or speaking for compensation should review the provisions of 5 CFR 2635.807 (Teaching, Speaking, and Writing).

For the reasons set out in the preamble, Title 17, Chapter II, Part 200, subpart M of the Code of Federal Regulations is amended as follows:

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

2. The general authority citation for part 200, subpart M is revised to read as follows:

Subpart M – Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission

Authority: 15 U.S.C. 77s, 77sss, 78w, 80a-37, 80b-11; E.O. 11222, 3 CFR, 1964-1965 Comp., p. 36; 5 CFR 735.104; 5 CFR 2634; and 5 CFR 2635, unless otherwise noted.

3. § 200.735-1 is amended as follows:

(a) Revising § 200.735-1 to read as follows; and

(b) Removing footnote 1.

This revision reads as follows:

§ 200.735-1 Purpose.

This subpart sets forth the standards of ethical conduct required of members, employees and special Government employees, and former members and employees of the Securities and Exchange Commission.

4. § 200.735-2(b) is revised to read as follows:

§ 200.735-2 Policy.

* * * * *

(b) For these reasons, members, employees, and special Government employees should at all times abide by the standards of ethical conduct for employees of the executive branch (codified in 5 CFR 2635); the supplemental standards of ethical conduct for members and employees of the Securities and Exchange Commission (codified in 5 CFR 4401); the standards of conduct set forth in this subpart; the Canons of ethics for members of the Securities and Exchange Commission (codified in subpart C of this part 200); and, in the case of a person practicing a profession as defined in 5 CFR 2636.305(b)(1), the applicable professional ethical standards.

5. § 200.735-3 is amended by:

(a) Revising paragraph (a);

(b) Removing footnote 2 in paragraph (b)(1);

(c) Removing paragraphs (b)(2) through (b)(6) and footnotes 3 and 4 in paragraphs (b)(3)(vi) and (b)(6) respectively;

(d) Redesignating paragraph (b)(7) as paragraph (b)(2), removing footnote 5 in paragraph (b)(7)(i), redesignating footnote 6 in paragraph (b)(7)(iii) as footnote 1 and deleting the words "section 22(c) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79y) and Rule 104 thereunder (17 CFR 250.104)" and deleting the words "But see, section 171 of the Administrative Manual which authorizes the staff to divulge certain nonpublic information with Commission approval (n. 5, supra)." from the newly redesignated footnote 1 to newly redesignated paragraph (b)(2);

(e) Removing paragraphs (b)(8) through (b)(12) and footnote 7 in paragraph (b)(8); and

(f) Adding paragraphs (c), (d), (e), (f), (g), and (h).

The revision and additions read as follows:

§ 200.735-3 General provisions.

(a) A member or employee shall comply with the requirements of 5 CFR 2635, subpart A (General provisions) and in particular with the provisions of 5 CFR 2635.101 (Basic obligations of public service); 2635.103 (Applicability to members of the uniformed services); and 2635.104 (Applicability to employees on detail).

* * * * *

(c) A member or employee shall comply with the requirements of 5 CFR 2635 subpart B (Gifts from outside sources).

(d) A member or employee shall comply with the requirements of 5 CFR 2635, subpart C (Gifts between employees).

(e) A member or employee shall comply with the requirements of 5 CFR 2635, subpart D (Conflicting financial requirements);

(f) A member or employee shall comply with the requirements of 5 CFR 2635, subpart E (Impartiality).

(g) A member or employee shall comply with the requirements of 5 CFR 2635, subpart G (Misuse of position).

(h) No member or employee shall accept host-paid travel or reimbursement except as in accordance with the requirements of the Supplemental standards of ethical conduct for members and employees of the Securities and Exchange Commission (codified at 5 CFR 4401.103 (Outside Employment and Activities)); 5 CFR 2635, subpart H (Outside Activities); and 31 U.S.C. 353 and 41 CFR 304-1.1 (Acceptance of payment from a non-federal source for travel expenses).

6. §200.735-4 is amended by:

(a) Revising paragraph (a) and removing footnote 8 to paragraph (a);

(b) Removing paragraphs (b)(1) through (b)(4) and paragraphs (b)(6) through (b)(8);

(c) Redesignating paragraph (b)(5) as paragraph (b) and redesignating footnotes 9 and 10 in paragraphs (b)(5) and (b)(5)(ii) as footnotes 2 and 3 respectively and removing the words "(See 17 CFR 200.735-4(b)(7))" from newly redesignated footnote 2;

(d) Removing footnote 11;

(e) Revising paragraph (c) and removing footnotes 12, 13, and 14;

(f) Removing paragraph (d);

(g) Redesignating paragraph (e) as paragraph (d) and removing footnote 15 in newly redesignated paragraph (d)(1) and adding new footnote 4 to newly redesignated paragraph (d)(1);

(h) In newly redesignated paragraph (d)(1), removing the words "paragraph (b)(5)" and, in their place, adding "paragraph (b)", and revising newly redesignated paragraph (d)(2)(ii);

(i) Redesignating paragraphs (f) and (g) as paragraphs (g) and (h);

(j) Adding new paragraphs (e) and (f);

(k) Removing footnote 16 in paragraph (g) and the authority citation at the end of the section.

The revisions read as follows:

§200.735-4 Outside employment and activities.

(a) Members and employees shall comply with the requirements of the Supplemental standards of ethical conduct for members and employees of the Securities and Exchange Commission (codified at 5 CFR 4401.103 (Outside employment and activities) and 5 CFR 2635, subpart H (Outside activities)).

* * * * *

(c) If otherwise permitted by 18 U.S.C. 203 and 205, the provisions of these rules or of 5 CFR 4401.103 do not preclude an employee from acting as agent or attorney:

(1) For any Commission employee who is sued or under investigation in connection with his or her official duties;

(2) For any Commission employee who is the subject of disciplinary, loyalty, or other personnel administrative proceedings in connection with those proceedings; or

(3) For any Commission employee who raises claims or against whom allegations of wrongdoing are made pursuant to the Commission's Equal Opportunity regulations, if such representation is not inconsistent with the faithful performance of the employee's duties.

(d)(1) * * * [4]

* * *

(2) * * *

(ii) A determination by the General Counsel that a proposed publication conforms to the requirements of the rule will not involve adoption of, or concurrence in, the views expressed. Therefore, such publication or speech shall include at an appropriate place or in a footnote or otherwise, the following disclaimer of responsibility:

The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner.

This [article, outline, speech, chapter] expresses the author's views and does not necessarily reflect those of the Commission, the [other] Commissioners, or [other] members of the staff.

In appropriate cases, the above disclaimer may be modified by the General Counsel or the Commission to reflect the circumstances of an individual case. In addition, any publication or speech that reflects positions taken by the Commission shall set forth those

[4] This paragraph (d), requiring review of prepared speeches or writings relating to the Commission does not apply to teaching activities.

positions accurately and, if it contains differences with Commission positions, it shall clearly state that such positions are those of the employee.

(e) With respect to host-paid travel, members and employees shall comply with the requirements of the Supplemental standards of ethical conduct for members and employees of the Securities and Exchange Commission (codified at 5 CFR 4401.103 (Outside employment and activities)); 5 CFR 2635, subpart H (Outside Activities); and 31 U.S.C. 1353 and 41 CFR 304-1.1 (Acceptance of payment from a non-federal source for travel expenses).

(f)(1) With respect to seeking or negotiating outside employment, members and employees shall comply with the requirements of the Supplemental standards of ethical conduct for members and employees of the Securities and Exchange Commission (codified at 5 CFR 4401.103 (Outside employment and activities)); 5 CFR 2635, subpart F (Seeking other employment); CFR 2635, subpart H (Outside activities).

(2) Members and employees should be aware that 18 U.S.C. 208 (Acts affecting a personal interest) provides, among other things, that a member or employee is prohibited from participating personally and substantially in any particular matter in which, to his or her knowledge, the member or employee, his or her spouse, minor child, general partner, organization of which the employee is an officer, director, trustee, general partner or employee, or any person or organization with whom he or she is negotiating or has any arrangement concerning prospective employment, has a financial interest. This provision does not apply if the employee has received a written determination by an authorized official that the financial interest is not so substantial as to be deemed likely to affect the integrity of the employee's government service.

(3) Members may follow the procedural provision contained in Part V, Section 503 of the Executive Order 11222.

* * * * *

7. § 200.735-5 is amended by:

(a) Revising § 200.735-5; and

(b) Removing footnote 17 in paragraph (b)(1)(ii).

The revision reads as follows:

§ 200.735.5 Securities transactions.

Securities transactions by members and employees must comply with the provisions of 5 CFR 4401.102 (Prohibited and restricted financial interests and transactions).

8. § 200.735-6 is amended by:

(a) Revising § 200.735-6; and

(b) Removing footnote 18.

The revision reads as follows:

§ 200.735-6 Action in case of personal interest.

Members and employees shall comply with the requirements of 5 CFR 2640 (Interpretation, exemptions, and waiver guidance concerning 18 U.S.C. 208 (Acts affecting a personal interest)).

9. § 200.735-7 is amended by:

(a) Revising 200.735-7;

(b) Removing footnote 19 in paragraph (c).

The revision reads as follows:

Chairman Schapiro and Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62500 / July 14, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13830

In the Matter of JOHN F. KENDRICK, Respondent.	ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b), 15B(c)(4) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

On March 24, 2010, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b), 15B(c)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against John F. Kendrick ("Kendrick" or "Respondent").

II.

In response to these proceedings, Respondent Kendrick has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b), 15B(c)(4) and 21C of Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

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

Respondent

1. Respondent was the senior vice president of public finance for New England in Southwest Securities, Inc.'s Medfield, Massachusetts branch office between December 1, 2000 and July 2009. Kendrick was also a registered representative associated with Southwest Securities, Inc., a registered broker-dealer and municipal securities dealer. Kendrick, 65 years old, is a resident of Medfield, Massachusetts.

Other Relevant Entity

2. Southwest Securities, Inc. ("Southwest"), incorporated in Delaware in 1991, is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act since September 1, 1992 and with the Municipal Securities Rulemaking Board ("MSRB") as a municipal securities dealer as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act. Southwest's principal place of business is in Dallas, Texas. At all times relevant to these proceedings, Southwest was a wholly-owned subsidiary of SWS Group, Inc.

Background

3. Between December 2000 and July 2009, Kendrick engaged in activities that constituted solicitation of municipal securities business from certain issuers on behalf of Southwest. As a result, Kendrick was a "municipal finance professional" ("MFP") associated with Southwest under MSRB Rule G-37. [2]

4. Between 2003 through 2008, Kendrick contributed $1,625 to Timothy Cahill, the treasurer of the Commonwealth of Massachusetts (hereinafter "the treasurer"). The treasurer was an incumbent who was also at the time of the contributions a candidate for elective office in the Commonwealth of Massachusetts.[3] The contributions were made through seven different checks

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2 Rule G-37(g)(iv)(B) provides that "the term 'municipal finance professional' [includes] . . . any associated person [of a broker, dealer or municipal securities dealer] who solicits municipal securities business." According to MSRB interpretations, soliciting municipal securities business includes, but is not limited to, responding to issuer requests for proposals. *See* MSRB Notice 2006-15 (June 15, 2006). Kendrick engaged in municipal securities solicitation activities by signing cover letters attached to responses to requests for qualifications ("RFQ") for underwriting business and by having his name appear in the responses to the RFQs as a member of Southwest's underwriting team. Although Kendrick engaged in both of these solicitation activities, either one by itself was sufficient to make him an MFP.

3 Rule G-37(g)(vi) defines an "official of such issuer" as any person who was, at the time of the contribution, an incumbent, candidate or successful candidate: (A) for elective office of the issuer which office is directly or indirectly responsible for, or can influence the outcome of, the hiring of a broker, dealer or municipal securities dealer for municipal securities business by the issuer; or (B) for any elective office of a state or of any political subdivision, which office has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of a broker, dealer or municipal securities dealer for municipal securities business by an issuer.

during two election cycles. Specifically, on February 8, 2003, March 25, 2004 and June 22, 2005, Kendrick contributed $250 to the treasurer through three different personal checks, for a total of $750. These contributions were all made before the state primary election in 2006. The contributions on March 25, 2004 and June 22, 2005 placed Kendrick's total contributions for the primary election above the $250 *de minimis* exception.[4] In addition, on December 15, 2006, May 29, 2007, December 10, 2007 and April 28, 2008, before the scheduled state primary election in 2010, in which the treasurer expected to be a candidate, Kendrick contributed $875 to the treasurer through four different personal checks. Each of the contributions on May 29, 2007, December 10, 2007 and April 28, 2008 placed Kendrick's total contributions above the $250 *de minimis* exception.

5. The treasurer is responsible for, or has the authority to appoint persons who are responsible for, the hiring of brokers, dealers, or municipal securities dealers for municipal securities business by the Commonwealth of Massachusetts and certain related state governmental units, including the Massachusetts Water Pollution Abatement Trust and the Massachusetts School Building Authority (hereinafter "the Issuers").

6. Under Rule G-37, each of these contributions above the $250 *de minimis* exception triggered a two-year ban on municipal securities business with the Issuers, starting with the dates of the contributions. Accordingly, during the first election cycle, Southwest was prohibited from engaging in municipal securities business with the Issuers for the period March 25, 2004 to June 22, 2007. During the second election cycle, Southwest was prohibited from engaging in municipal securities business with the Issuers for the period May 29, 2007 to April 28, 2010.

7. Within two years after the above non-*de minimis* contributions, Southwest, with Kendrick's knowledge, participated as co-manager for a total of 19 negotiated underwritings by the Issuers totaling approximately $14 billion.

8. In June 2005, Kendrick co-hosted a fundraiser for the treasurer. Kendrick made approximately 82 solicitation requests for campaign contributions relating to the fundraiser. In addition, Kendrick personally delivered his own check, and the checks that he solicited from others, to a representative of the treasurer's campaign. The fundraiser raised approximately

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4 A *de mininis* exception to Rule G-37(b) allows an MFP to contribute up to $250 per candidate per election if the MFP is entitled to vote for the candidate. If an issuer official is involved in a primary election prior to the general election, an MFP who is entitled to vote for such official can contribute a total of $500 to that official—up to $250 for the primary and up to $250 for the general election. Although an MFP is permitted to contribute a total of $500 per election cycle, the rule limits contributions to $250 before the primary, with an additional $250 allowed after the primary for the general election. *See, e.g.,* MSRB G-37 Q&As, Q&A No. II.8 (May 24, 1994); *Pryor, McClendon, Counts & Co., Inc. et al.*, Exchange Act Release No. 48095 (June 26, 2003), 2003 SEC LEXIS 1503 ("Rule G-37 limited contributions to $250 before the primary, with an additional $250 allowed after the primary for the general election.").

$9,000 for the treasurer's campaign committee. At the same time of the solicitations, Southwest was engaged in or seeking to engage in municipal securities business through a response to a request for qualifications sent to the Issuers.

Violations

9. As a result of the conduct described above, Kendrick caused Southwest's violations of MSRB Rule G-37(b), which prohibits brokers, dealers or municipal securities dealers from engaging in municipal securities business with an issuer within two years after any contribution to an official of such issuer made by (i) the broker, dealer or municipal securities dealer; (ii) any municipal finance professional associated with such broker, dealer or municipal securities dealer; or (iii) any political action committee controlled by the broker, dealer or municipal securities dealer or by any municipal finance professional, unless the contribution is exempt.

10. As a result of the conduct described above, Kendrick willfully violated Rule G-37(c) of the MSRB, which prohibits, among other things, brokers, dealers, municipal securities dealers or any municipal finance professional of the broker, dealer or municipal securities dealer from soliciting any person to make any contributions or coordinating any contributions to an official of an issuer with which the broker, dealer or municipal securities dealer is engaging or is seeking to engage in municipal securities business.[5]

11. As a result of the conduct described above, Kendrick caused Southwest's violations of Section 15B(c)(1) of the Exchange Act, which prohibits a broker, dealer or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB.

Civil Penalties

12. Respondent has submitted a sworn Statement of Financial Condition dated March 9, 2010 and other evidence, including an additional Affidavit dated May 28, 2010, and has asserted his inability to pay a civil penalty in excess of $10,000.

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[5] Rule G-37 is a broad prophylactic measure. Finding a violation of Rule G-37(b), Rule G-37(c) and Section 15B(c)(1) of the Exchange Act does not require a showing of scienter or a *quid pro quo*. 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)).

IV.

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

Accordingly, pursuant to Sections 15(b), 15B(c)(4), 21B and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Kendrick cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act, MSRB Rule G-37(b) and MSRB Rule G-37(c).

B. Respondent Kendrick shall pay $10,000 as a civil money penalty to the United States Treasury. Based upon Respondent's sworn representations in his Statement of Financial Condition dated March 9, 2010, an Affidavit dated May 28, 2010 and other documents submitted to the Commission, the Commission is not imposing a larger penalty against Respondent.

C. Respondent shall pay the civil penalty in two installments of $5,000 with the first installment due within 10 days of the entry of this Order and the remaining $5,000 of which he must pay within 180 days of the entry of this Order. 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 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 John F. Kendrick as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Regional Director, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, Suite 2300, Boston, MA 02110;

D. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 239, 240, 249, 270 and 274

[Release Nos. 33-9128; 34-62544; IC-29367; File No. S7-15-10]

RIN 3235-AJ94

Mutual Fund Distribution Fees; Confirmations

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "the Commission") is proposing a new rule and rule amendments that would replace rule 12b-1 under the Investment Company Act, the rule that has permitted registered open-end management investment companies ("mutual funds" or "funds") to use fund assets to pay for the cost of promoting sales of fund shares. The new rule and amendments would continue to allow funds to bear promotional costs within certain limits, and would also preserve the ability of funds to provide investors with alternatives for paying sales charges (*e.g.*, at the time of purchase, at the time of redemption, or through a continuing fee charged to fund assets). Unlike the current rule 12b-1 framework, the proposed rules would limit the cumulative sales charges each investor pays, no matter how they are imposed. To help investors make better-informed choices when selecting a fund that imposes sales charges, the Commission is also proposing to require clearer disclosure about all sales charges in fund prospectuses, annual and semi-annual reports to shareholders, and in investor confirmation statements.

As part of the new regulatory framework, the Commission is proposing to give funds and their underwriters the option of offering classes of shares that could be sold by dealers with sales charges set at competitively established rates – rates that could better reflect the services offered

by the particular intermediary and the value investors place on those services. For funds electing this option, the proposal would provide relief from restrictions that currently limit retail price competition for distribution services.

The proposed rule and rule amendments are designed to protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate role for fund directors, and allow greater competition among funds and intermediaries in setting sales loads and distribution fees generally.

DATES: Comments must be received on or before November 5, 2010.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-15-10 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 Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-15-10. 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:

With respect to rules and forms under the Investment Company Act and Securities Act, Thoreau A. Bartmann, Senior Counsel, Daniel Chang, Attorney, or C. Hunter Jones, Assistant Director, at 202-551-6792, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

With respect to rule 10b-10 under the Securities Exchange Act, Daniel Fisher, Branch Chief, or Ignacio Sandoval, Attorney, at 202-551-5550, Office of Chief Counsel, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commission is proposing to rescind rule 12b-1 [17 CFR 270.12b-1] under the Investment Company Act of 1940 ("Investment Company Act" or "Act").[1] The Commission is also proposing for comment: new rule 12b-2 [17 CFR 270.12b-2] under the Investment Company Act; amendments to rules 6c-10 [17 CFR 270.6c-10] and 11a-3 [17 CFR 270.11a-3] under the Investment Company Act; amendments to Form N-1A[2] under the

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

2 17 CFR 239.15A and 274.11A.

Investment Company Act and the Securities Act of 1933 ("Securities Act");[3] amendments to rule 6-07 [17 CFR 210.6-07] of Regulation S-X under the Securities Act; amendments to rule 10b-10 [17 CFR 240.10b-10] and Schedule 14A[4] under the Securities Exchange Act of 1934 ("Exchange Act");[5] technical changes to rule 10b-10; and technical and conforming changes to various rules and forms under the Investment Company Act.

3 15 U.S.C. 77a.

4 17 CFR 240.14a-101.

5 15 U.S.C. 78a.

TABLE OF CONTENTS

I. INTRODUCTION

More than 87 million Americans, representing slightly less than half of all households, own mutual funds.[6] Some investors buy fund shares directly from mutual fund sponsors without paying a sales charge.[7] However, most fund investors buy through intermediaries.[8] These intermediaries include broker-dealers, banks, insurance companies, financial planners, and retirement plans. When investors use intermediaries to buy fund shares, they typically will pay (either directly or indirectly) some form of sales charge or service fees to compensate the intermediaries for the services they provide.[9]

Investors use intermediaries for a variety of reasons. Some want help in selecting a particular fund or building a diversified portfolio of investments. Others like the convenience of holding a variety of financial assets together in the same account and receiving a single comprehensive account statement. A growing number of investors use mutual funds as a way to fund their retirement plans, college savings accounts, annuity or life insurance contracts, or other

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6 Investment Company Institute ("ICI"), *Profile of Mutual Fund Shareholders, 2009* (2010) ("Shareholder Profile Report") (http://ici.org/pdf/rpt_profile10.pdf). Mutual funds' share of household financial assets has grown steadily from 3 percent in 1980 to 21 percent in 2009. ICI, 2010 INVESTMENT COMPANY FACT BOOK at 10 (2010) (http://www.ici.org/pdf/2010_factbook.pdf) ("2010 ICI FACT BOOK").

7 These are referred to as "no-load" funds because no sales charge or "load" is charged in connection with the transaction. *See infra* notes 16-17 and accompanying text.

8 According to the ICI, 80 percent of U.S. households that own mutual funds outside of retirement plans hold some portion of their fund shares through financial professionals (including brokers, financial planners, insurance agents, bank representatives, and accountants). 2010 ICI FACT BOOK, *supra* note 6, at 85.

9 Although the use of the term "intermediary" in this Release is not limited to registered broker-dealers, receipt of the fees addressed in this Release may, depending on the services provided, require the recipient to register as a broker-dealer or rely on an exception or exemption from broker-dealer registration. *See also* note 168, *infra,* and accompanying text.

tax-advantaged investment vehicles, which are often offered by an intermediary.[10] In some cases, investors use an intermediary (and pay sales charges) not necessarily for the services they obtain from the intermediary, but simply to be able to invest in shares of a particular fund that they cannot buy directly (*i.e.,* that are sold only through intermediaries).

There are over 9,000 funds available to investors, offering a variety of investment strategies to suit different investment needs.[11] Investors can select among many types of intermediaries from which they can purchase fund shares, and have choices as to how they pay for the services of those intermediaries. They may pay a "sales load" at the time they purchase shares, or a deferred sales load when they redeem shares, or they may invest in a fund that pays ongoing sales charges on behalf of investors from fund assets, otherwise known as 12b-1 fees.[12] As an alternative, they may choose to invest through an intermediary that deducts fees directly from the investor's account by a separate agreement (*e.g.,* "wrap fee programs"). Whether an investor pays sales charges depends upon the fee structure of the fund in which the investor chooses to invest, and how those sales charges are paid depends upon the "class" of fund shares that the investor selects.[13]

These sales charge arrangements are disclosed in fund prospectuses, and are governed by a combination of statutory provisions and rules adopted by the Commission and the Financial

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10 *See* 2010 ICI FACT BOOK, *supra* note 6, at 97, 118. According to the ICI, U.S. retirement plan assets totaled $16 trillion in 2009. *Id.* The largest individual components were Individual Retirement Accounts ("IRAs") and employer-sponsored defined contribution plans, holding assets of $4.2 trillion and $4.1 trillion, respectively. Mutual funds' share of the IRA market has increased from 22 percent in 1990 to 46 percent in 2009. *Id.* at 98-99. Assets in section 529 college savings plans have grown from $2.6 billion in 2000 to $111 billion in 2009. *Id.* at 118.

11 2010 ICI FACT BOOK, *supra* note 6, at 16. This figure represents the total number of registered open-end funds, and includes separate series of a fund and ETFs.

12 We will use the term "12b-1 fees" generally to describe fees that are paid out of fund assets pursuant to a plan adopted under rule 12b-1 ("12b-1 plan").

13 *See infra* Section II.C.3 of this Release.

Industry Regulatory Authority, Inc. ("FINRA"), a self-regulatory organization for broker-dealers.[14] These rules have been in place for many years and, as discussed in more detail below, we believe that they may no longer fully reflect the current economic realities of the mutual fund marketplace or best serve the interests of fund investors. In this Release, we first review how these rules developed, our experience in administering them, changes we have observed in how funds distribute their shares, and the evolving needs of shareholders. We then propose a new framework that would continue to allow funds to give investors choices as to how and when to pay for sales charges, improve disclosure designed to enhance investor understanding of those charges, limit the cumulative sales charges each investor pays, and eliminate uncertainties associated with current requirements while providing a more appropriate role for fund directors. Finally, the proposal would offer funds and their underwriters the option of offering a class of shares that could be sold by intermediaries subject to competition in establishing sales charge rates.

II. BACKGROUND

A. Mutual Fund Sales Charges

When the Investment Company Act was enacted in 1940, investors paid most of the costs of selling and promoting fund shares in the form of a sales charge or sales "load" deducted from the purchase price at the time of sale by the fund's principal underwriter (typically the fund's adviser or a close affiliate).[15] The sales load financed brokers' commissions, advertisements, and

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14 FINRA rules do not apply directly to mutual funds, but to registered broker-dealers that are FINRA members, including the principal underwriters of most funds. Most funds therefore structure their sales loads to meet FINRA rules in order for their shares to be distributed and sold by registered broker-dealers in the United States.

15 *See* SEC, *INVESTMENT TRUSTS AND INVESTMENT COMPANIES*, H.R. Doc. No. 279, 76th Cong., 1st Sess., pt. 3, at 813, 823 (1939) ("INVESTMENT TRUST STUDY"). Principal underwriters typically confine themselves to wholesale transactions and leave the public selling to independent retail dealers under sales agreements, although some underwriters have their own "captive" retail sales

other sales and promotional activities. Only a limited number of funds, called "no-load" funds, marketed their shares directly to investors without the assistance of a retail broker, and did not charge sales loads.[16] The selling costs of no-load funds (primarily advertising) typically were subsidized by the funds' investment advisers out of their profits.[17]

In the past, fund sales charges generally were much higher than those customarily charged today and raised concerns for Congress and the Commission.[18] The Commission submitted a report to Congress in 1966 concluding that mutual fund sales charges should be lowered.[19] Following this report, Congress amended the Act in 1970 to give rulemaking authority to the National Association of Securities Dealers, Inc. ("NASD") (now FINRA) to prescribe limits to prevent excessive sales loads.[20] Under this authority, in 1975, the NASD

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organizations. *See* Tamar Frankel, THE REGULATION OF MONEY MANAGERS, § 27.01 (2009 supplement) ("THE REGULATION OF MONEY MANAGERS"). *See also* DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 291 (1992) ("1992 STUDY"). Although the principal underwriter collects the sales load, for convenience, throughout this Release, we will simply refer to "funds" as imposing sales loads or determining the amount of sales load payable.

16 *See* INVESTMENT TRUST STUDY, *supra* note 15, at 817-18. Some funds also charged low sales loads of one to two percent. *Id.*

17 *See* 1992 STUDY, *supra* note 15, at 292.

18 During the period of 1927-1935, sales loads for broker-sold funds ranged from five to 10 percent, but by 1935 they were often as high as nine to 10 percent. *See* INVESTMENT TRUST STUDY, *supra* note 15, pt. 2, 216-17. *See also Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 799 (1940) (statement of L.M.C. Smith, Associate Counsel, Investment Trust Study, SEC, discussing the "problem" of high sales loads).

19 The Commission recommended that sales loads be limited to a statutory maximum of five percent from the prevailing typical load of 9.3 percent. *See* SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. at 205, 223 ("PPI REPORT").

20 Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 12(a), 84 Stat.1413, 1422 (1970) (codified as amended at section 22(b) of the Act). Section 22(b) vested this rulemaking authority in a securities association registered under section 15A of the Exchange Act. The NASD (now FINRA) was and is the only such registered securities association. The Commission supported the amendment. *See Investment Company Amendments Act of 1970: Hearings on S. 34 and S. 296*

adopted a rule placing a ceiling of 8.5 percent on the front-end sales load that a fund distributed by NASD members could charge.[21] Today, few funds impose sales loads that approach the maximum limit, in part because of investor resistance to paying high front-end loads, but also because of the availability of other sources of revenue to pay distribution costs.[22]

B. Adoption of Rule 12b-1

The most significant of these alternative revenue sources came about when the Commission adopted rule 12b-1 in 1980.[23] As described in more detail below, rule 12b-1 permits a fund to use fund assets to pay broker-dealers and others for providing services that are primarily intended to result in the sale of the fund's shares. The Commission adopted rule 12b-1 under its authority in section 12(b) of the Investment Company Act,[24] which authorizes the Commission to regulate the distribution activities of funds that act as distributors of their own securities.[25] Section 12(b) was designed to protect funds from being charged excessive sales and promotional expenses.[26] The requirements of the rule are intended, in part, to address the

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Before a Subcomm. of the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess. 6-8 (1969) (statement of Hugh Owens, SEC Commissioner).

21 Order Approving Proposed Rule Change by NASD, Investment Company Act Release No. 8980 (Oct. 10, 1975) (approving predecessor rule to NASD Conduct Rule 2830).

22 *See* THE REGULATION OF MONEY MANAGERS, *supra* note 15, at § 27.03; ICI, *Trends in the Fees and Expenses of Mutual Funds, 2009* (Apr. 2010) (http://www.ici.org/pdf/fm-v19n2.pdf) ("Fee Trends Report") (noting that in 2009 the average maximum front-end load on stock funds was 5.3 percent).

23 Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)] ("1980 Adopting Release").

24 Rule 12b-1 was also adopted pursuant to section 38(a) of the Act. *Id.*

25 Section 12(b) makes it unlawful, with certain exceptions, for any mutual fund "to act as a distributor" of its own shares in contravention of any rules the Commission adopts as "necessary or appropriate in the public interest or for the protection of investors."

26 *See* Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 112 (1940) ("House Hearings") (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC) (The purpose of section 12(b) is to prevent mutual funds from incurring "excessive sales, promotion expenses, and so forth.").

conflicts of interest between a fund and its investment adviser that arise when a fund bears its own distribution expenses.[27]

The Commission's adoption of rule 12b-1 arose in the context of two significant developments in the mutual fund market that occurred during the 1970s.[28] First, many funds experienced a prolonged period of net redemptions (*i.e.*, redemptions exceeded new sales), which reduced the amount of fund assets.[29] Fund company representatives asserted that using fund assets to fuel the sale of fund shares could benefit fund shareholders by increasing economies of scale and reducing fund expense ratios.[30] The second was the development of money market funds and no-load fund groups, including internally managed funds, which did not charge sales loads but required a source of revenue to support their direct selling efforts.[31] By offering a less

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27 When a fund pays promotional costs, the fund's investment adviser or distributor is relieved from bearing the expense itself, and the adviser benefits further if the fund's expenditures result in the growth of the fund's assets and a related increase in advisory fees (because an adviser's fees typically are based on a percentage of fund assets). However, commentators have noted that the benefits to existing fund shareholders from these expenditures may be "speculative at best." *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10252 (May 23, 1978) [43 FR 23589 (May 31, 1978)] ("Advance Notice of Proposed Rulemaking") at text following n. 3.

28 *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 13, 1988) [53 FR 23258 (June 21, 1988)] ("1988 Release") at n.14 and accompanying text.

29 Total redemptions exceeded new sales for six of the seven years between 1971 and 1977. 2010 ICI FACT BOOK, *supra* note 6, at 125.

30 *See* Advance Notice of Proposed Rulemaking, *supra* note 27, at n.3 and accompanying text.

31 *See, e.g.*, Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)]. An investment company is said to have internalized its management functions when most or all of the services traditionally provided by the investment adviser or third parties are performed at cost by salaried employees of the fund or by subsidiaries of the fund. *See* 1988 Release, *supra* note 28, at n.8. When the Commission proposed rule 12b-1, an application was pending from The Vanguard Group for exemptions from the Act to permit Vanguard funds to internalize their marketing and distribution functions and to bear distribution costs through a wholly owned subsidiary of the funds. *See* In the Matter of the Vanguard Group, *et al.*, Opinion of the Commission, Investment Company Act Release No. 11645 (Feb. 25, 1981). The Commission discussed the Vanguard application in the release and asked commenters to address other possible methods whereby funds might be permitted to bear distribution expenses. *See*

expensive way for many investors to become fund shareholders, no-load funds promised to introduce greater price competition in the sale of mutual funds to retail investors, which might lower sales loads for all investors.

Before the rule's adoption, the Commission generally had opposed the use of fund assets for the purpose of financing the distribution of mutual fund shares, noting that existing shareholders of a fund "often derive little or no benefit from the sale of new shares."[32] After engaging in a thorough review of the public policy and legal implications of permitting funds to bear these types of expenses, which included a public hearing and two requests for public comment,[33] the Commission ultimately decided that there may be circumstances in which it would be appropriate for a fund to bear its own distribution expenses.[34]

The Commission remained concerned, however, about the inherent conflicts of interest on the part of the fund adviser.[35] Therefore, in crafting the conditions of the rule, we sought to minimize the role of the adviser and its affiliates in establishing both the amount and uses of

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Advance Notice of Proposed Rulemaking, *supra* note 27, at n.5. The Commission previously had allowed other funds with internalized management functions to pay distribution expenses out of fund assets because it believed these arrangements would significantly reduce the conflicts of interest that otherwise are present when fund assets are used to pay for distribution. *See* 1988 Release, *supra* note 28, at nn.8-10 and accompanying text.

32 *See* Bearing of Distribution Expenses by Mutual Funds: Statutory Interpretation, Investment Company Act Release No. 9915 (Aug. 31, 1977) [42 FR 44810 (Sept. 7, 1977)] (quoting SEC, Future Structure of the Securities Markets (Feb. 2, 1972) [37 FR 5286 (Mar. 14, 1972)]).

33 *See* Investment Company Act Release No. 9470 (Oct. 4, 1976) [41 FR 44770 (Oct. 12, 1976)] (announcement of hearings); Advance Notice of Proposed Rulemaking, *supra* note 27; Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10862 (Sept. 7, 1979) [44 FR 54014 (Sept. 17, 1979)] ("1979 Proposing Release").

34 The Commission noted, however, that it and its staff would "monitor the operation of the rules closely and will be prepared to adjust the rules in light of experience to make the restrictions on use of fund assets for distribution either more or less strict." *See* 1980 Adopting Release, *supra* note 23, at section titled "Discussion."

35 *See id.*

fund assets to support distribution.[36] As adopted, the rule required the fund's board of directors, and in particular its independent directors, to play a key role in deciding the level of the fund's distribution charges and how the revenue would be spent.[37]

Rule 12b-1 requires that, before using fund assets to pay for distribution expenses, a fund must adopt a written plan (a "rule 12b-1 plan") describing all material aspects of the proposed financing of distribution,[38] which must contain provisions similar to several of those the Act requires for advisory contracts between the fund and its investment adviser.[39] The rule 12b-1 plan must be approved initially by the fund's board of directors as a whole, and separately by the "independent" directors.[40] If the plan is adopted after the sale of fund shares to the general public, it also must be approved initially by a vote of at least a majority of the fund's voting securities.[41]

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36 *See id.* at section titled "Independence of Directors." *See also* 1988 Release, *supra* note 28, at section titled "The Development and Use of 'Compensation' Plans" ("The directors' responsibilities under the rule were designed to provide that the directors, not advisers or underwriters, make the fundamental decisions regarding distribution spending.").

37 *See* 1980 Adopting Release, *supra* note 23, at section titled "Independence of Directors" ("Since rule 12b-1 does not restrict the kinds or amounts of payments which could be made, the role of the disinterested directors in approving such expenditures is crucial.").

38 Rule 12b-1(b). The plan must cover *indirect* as well as direct payments for distribution. *See* rule 12b-1(a)(2).

39 *See* 1980 Adopting Release, *supra* note 23, at section titled "Summary" ("The procedures in the rule by which shareholders and directors would approve a plan to use assets for distribution are generally similar to those prescribed by statute for approval of investment advisory contracts."). *See also* sections 15(a) and 15(c) of the Act.

40 We generally refer to directors who are not "interested persons" of the fund as "independent directors" or "disinterested directors." The term "interested person" is defined in section 2(a)(19) of the Act. However, rule 12b-1 requires directors to meet an additional test. In order to be considered independent for purposes of voting on a rule 12b-1 plan, directors must also have no direct or indirect economic interest in the operation of the plan or in any agreements related to the plan. Rule 12b-1(b)(2). In this Release, when we discuss the role of independent directors, the applicable standard for independence depends on the context.

41 Rule 12b-1(b)(1). When we originally adopted rule 12b-1 in 1980, shareholders were required to vote whenever a rule 12b-1 plan was instituted, regardless of whether a public offering of fund shares had occurred. *See* 1980 Adopting Release, *supra* note 23, at section titled "Procedural Requirements."

The rule does not restrict the amounts of the fees that may be approved under the plan.[42] It also does not specify all of the activities that are "primarily intended to result in the sale of shares" and therefore may be paid by a fund only according to a rule 12b-1 plan. Nor does it specifically prohibit a fund from paying for non-distribution expenses under a rule 12b-1 plan.[43] Instead of limits or restrictions, the rule requires directors (including a majority of the independent directors) to conclude, in exercising their reasonable business judgment and in light of their fiduciary duties, that there is a reasonable likelihood that the plan will benefit both the fund and its shareholders.[44] The directors have a duty to request and evaluate as much information as is reasonably necessary for the directors to make an informed business decision.[45] The rule also requires any person authorized to direct payments under the plan or any related agreement (such as the fund's underwriter) to provide quarterly reports to the board of directors of all amounts expended under the plan and the purposes for which the expenditures were made.[46] The fund's board of directors (including a majority of the independent directors) must

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However, if a rule 12b-1 plan is adopted prior to the public offering of shares, a shareholder vote would be a mere procedural formality and approval would be almost automatic because all shareholders voting would typically be the fund's organizers. Any investor who purchased shares in a public offering after the initial adoption of the plan would be on notice that the fund charges 12b-1 fees. Therefore, in 1996 we amended the rule to permit funds to adopt a 12b-1 plan prior to a public offering of shares without a shareholder vote. *See* Technical Amendments to Rule Relating to Payments for the Distribution of Shares by a Registered Open-End Management Investment Company, Investment Company Release No. 22201 (Sept. 9, 1996) [61 FR 49010 (Sept. 17, 1996)].

42 However, as discussed in more detail in Section II.C.1 of this Release, rules adopted by the NASD (now FINRA) prohibit broker-dealers from selling funds that pay more than 0.25 percent (25 basis points) per year of fund assets as "service fees," and more than 0.75 percent (75 basis points) per year of fund assets as "asset-based sales charges," effectively setting the maximum 12b-1 fees at those amounts or less. NASD Conduct Rule 2830(d)(5) and (d)(2)(E).

43 *See* 1988 Release, *supra* note 28, at n.129.

44 Rule 12b-1(e). The rule requires that the fund set forth and preserve in the corporate minutes the factors that the directors considered, together with the basis for the decision to use fund assets for distribution. Rule 12b-1(d).

45 Rule 12b-1(d).

46 Rule 12b-1(b)(3)(ii).

decide each year whether to re-approve the plan based on the same considerations as required initially to adopt the plan.[47] Any material increases in the amounts paid under the plan must be approved by the fund's board, the fund's independent directors, and the fund's shareholders.[48]

In the 1980 Adopting Release, the Commission provided a list of nine factors that were intended to provide guidance to directors in considering whether the use of fund assets for distribution would benefit the fund and its shareholders.[49] The factors included: (i) the need for independent counsel or experts to assist the board; (ii) the "problems" or "circumstances" that make the plan necessary or appropriate; (iii) the causes of such problems or circumstances; (iv) how the plan would address the problems; (v) the merits of possible alternatives; (vi) the interrelationships between the plan and distributors; (vii) the possible benefits of the plan to other persons relative to the benefits to the fund; (viii) the effect of the plan on existing shareholders; and (ix) in deciding whether to continue a plan, whether the plan has produced the anticipated benefits to the fund and its shareholders.[50]

The rule was intended to allow fund boards some latitude to exercise their reasonable business judgment to authorize the distribution arrangements and continue them from year to year as circumstances warranted.[51] The annual re-approval requirement and the factors

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47 Rule 12b-1(b)(3)(i).

48 Rule 12b-1(b)(4). Any other material changes to the plan must be approved by the fund's board and the fund's independent directors. Rule 12b-1(b)(2).

49 We originally included the factors in the text of the rule when we proposed it for public comment. *See* 1979 Proposing Release, *supra* note 33. In order to avoid the appearance of either unduly constricting the directors' decision-making process or of creating a mechanical checklist, we deleted the list of factors from rule 12b-1 at its adoption. Although we decided not to require the directors to consider any particular factors, the adopting release noted that the enumerated factors "would normally be relevant to a determination of whether to use fund assets for distribution." *See* 1980 Adopting Release, *supra* note 23, at section titled "Factors."

50 *See* 1980 Adopting Release, *supra* note 23, at section titled "Factors."

51 *Id.* at sections titled "Discussion" and "Independence of Directors." *See also* rule 12b-1(e) (providing that funds may implement or continue 12b-1 plans "only if the directors who vote to approve such

enumerated in our adopting release reflected an expectation that a fund would use the rule in order to address particular distribution problems, such as periods of net redemption.[52] The rule was also designed to allow distribution arrangements to evolve.[53] However, the rule ultimately resulted in distribution practices that we did not originally anticipate, as described below.[54]

C. Developments Following Rule 12b-1's Adoption

Initially, some funds adopted limited 12b-1 plans and used the revenue to pay for advertising and sales materials.[55] In time, however, funds began to adopt 12b-1 plans with higher fees and used the revenue to compensate fund intermediaries for sales efforts, rather than

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implementation or continuation conclude, in the exercise of reasonable business judgment ... that there is a reasonable likelihood that the plan will benefit the company and its shareholders"); rule 12b-1(b)(3) (requiring that a 12b-1 plan provide in substance that "it shall continue in effect for a period of more than one year from the date of its execution or adoption only so long as such continuance is specifically approved at least annually" by the fund's board of directors as a whole, and separately by the independent directors).

[52] *See* 1980 Adopting Release, *supra* note 23, at section titled "Factors." *See also* DIV. OF INV. MGMT., SEC, REPORT ON MUTUAL FUND FEES AND EXPENSES (2000) (http://www.sec.gov/news/studies/feestudy.htm); Joel H. Goldberg and Gregory N. Bressler, *Revisiting Rule 12b-1 under the Investment Company Act*, 31 SEC. & COMMODITIES REG. REV. 147, 151 (1998) ("Goldberg and Bressler") (factors "presuppose that the 12b-1 plan is designed to solve a particular distribution 'problem' or to respond to specific 'circumstances,' *e.g.*, net redemptions"); Lee R. Burgunder and Karl O. Hartmann, *The Mutual Fund Industry and Rule 12b-1 Plans: An Assessment*, 15 SEC. REG. L.J. 364 (1988) ("although the rule does not state this directly, the historical circumstances surrounding its preparation as well as its legislative history strongly [indicate] that the rule is aimed at the possible problems associated with periods of stagnant growth or net redemptions, especially for relatively small mutual funds").

[53] *See* 1980 Adopting Release, *supra* note 23, at section titled "General Requirements" ("Recognizing that new distribution activities may continuously evolve in the future, and in view of the impracticability of developing an all-inclusive list, the Commission maintains that the better approach is to define distribution expenses in conceptual terms ....").

[54] *See* 1988 Release, *supra* note 28, at paragraph preceding n.46 ("The use of the rule by the fund industry has resulted in many distribution practices that could not have been anticipated when the rule was adopted.").

[55] *See* Goldberg and Bressler, *supra* note 52, at 150. The first 12b-1 plans provided for payments of 0.25 percent or less of average annual net assets and generally were used only to reimburse advisers and underwriters for advertising expenses and the printing and mailing of prospectuses and sales literature. *Id.*

simply defraying promotional costs.[56] These 12b-1 plans often were coupled with contingent deferred sales loads, or "CDSLs," as part of a "spread load" arrangement, and served as an alternative to a front-end sales load.[57]

Unlike a traditional load, which is commonly referred to as a "front-end" load because it is paid at the time of purchase, fund investors pay a CDSL from their proceeds when they redeem shares.[58] The load is "contingent" because the amount payable reduces over time and usually disappears at the end of a stated period. When combined with the payment of 12b-1 fees, a CDSL operates as a deferred payment plan for sales charges.[59] Instead of paying a sales load at the time of purchase, a greater portion of the investor's money is invested in the fund at the outset, and the investor pays sales charges over time, albeit indirectly through charges against fund assets. An investor who redeems early compensates the fund underwriter (which has already advanced payments to intermediaries) by paying the CDSL in place of uncollected revenues from 12b-1 fees attributable to the investor's assets.

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56 *See* 1992 STUDY, *supra* note 15, at 322.

57 *See* Exemptions for Certain Registered Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 16619 (Nov. 2, 1988) [53 FR 45275 (Nov. 9, 1988)] ("Rule 6c-10 Proposing Release") (proposing to permit funds to impose CDSLs, which were often used in combination with 12b-1 plans "as a substitute for charging investors a front-end sales load").

58 Rule 22c-1 under the Act requires mutual funds to redeem shares at a price based on their net asset value. In order to impose CDSLs, funds sought and we granted exemptions from this and other provisions to permit shareholders to defer their payment of sales charges until redemption. *See, e.g.,* E.F. Hutton Investment Series, Inc., Investment Company Act Release Nos. 12079 (Dec. 4, 1981) [46 FR 60703 (Dec. 11, 1981)] (notice) and 12135 (Jan. 4, 1982) (order). After issuing numerous exemptions, we codified them in rule 6c-10, which permits funds complying with the rule to impose CDSLs without first having to obtain individual exemptions. Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 20916 (Feb. 23, 1995) [60 FR 11890 (Mar. 1, 1995)]. We later amended the rule to permit other types of deferred sales loads, including a form of account-level sales charge we referred to as an "installment load." Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 22202 (Sept. 9, 1996) [61 FR 49011 (Sept. 17, 1996)] ("1996 Rule 6c-10 Amendments").

59 *See* 1988 Release, *supra* note 28, at n.69 and accompanying text.

These spread load arrangements raised a number of concerns for the Commission. First, the 12b-1 fees were higher than expected[60] and seemed inconsistent with one of the original arguments that fund managers had advanced in support of rule 12b-1, which was to facilitate the creation of economies of scale that would lower expenses for fund shareholders.[61] Moreover, these plans took on the appearance of more permanent arrangements, which threatened to undermine the role of fund directors in managing the use of fund assets for distribution because the arrangements created multi-year business obligations on the part of distributors. As a practical matter, the arrangements limited the ability of fund directors to terminate the plan because ending the plan would deny distributors their future payments.[62]

The Commission responded to these developments by proposing amendments to rule 12b-1 in 1988, which effectively would have prohibited spread load arrangements.[63] Many commenters opposed the proposed amendments, arguing that spread load plans benefited

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60 *Id.* at nn.116-23 and accompanying text. *See also* Goldberg and Bressler, *supra* note 52, at nn.22-24 and accompanying text.

61 *See* Advance Notice of Proposed Rulemaking, *supra* note 27, at n.3 and accompanying text ("Commentators also argued that the use of fund assets to finance distribution activities could lead to increased sales of shares, thereby alleviating the difficulties perceived to result from net redemptions or small asset size," such as higher expense ratios.). The Commission's concern about the changing uses of 12b-1 fees was later reflected in the 1988 proposal to amend rule 12b-1. The amendments would have required annual shareholder approval of 12b-1 plans, because "while shareholders may see good reason to approve a plan in the early years of a fund to stimulate growth to a sufficient level for economies of scale to be achieved, they may have a quite different opinion of the utility of a 12b-1 plan once a fund has matured." 1988 Release, *supra* note 28, at text following n.187.

62 1988 Release, *supra* note 28 at section titled "The Development and Use of 'Reimbursement' Plans." *See also* Goldberg and Bressler, *supra* note 52 ("It would be economic folly ... for a mutual fund underwriter continually to advance sales commissions to selling dealers as part of a CDSL arrangement if it were not virtually certain that the 12b-1 plan would continue in effect indefinitely.").

63 *See* 1988 Release, *supra* note 28, at nn.144-50 and accompanying text. Among other things, the 1988 proposed amendments would have required that payments under a 12b-1 plan be made on a "current basis," which would have restricted the ability of a fund to pay for distribution expenses incurred on the fund's behalf in prior years (such as when the underwriter advances payment of the sales load to the broker after completion of the sale). In addition, the proposed amendments would have required payments made under a rule 12b-1 plan to be tied to specific distribution services actually provided to the fund and its shareholders. *See also* 1992 STUDY, *supra* note 15, at 323.

investors by permitting them to defer their distribution costs and avoid high front-end loads.[64] The Commission never adopted those amendments. Instead, over the years, the Commission sought to address the developing concerns raised by rule 12b-1 by other means, as discussed below.[65]

1. Imposition of Sales Load Caps

In 1992, the Commission approved amendments to NASD Conduct Rule 2830 (the "NASD sales charge rule"), which had the effect of limiting the maximum amount of 12b-1 fees that many funds could deduct from fund assets pursuant to a rule 12b-1 plan, based roughly on

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64 *See, e.g.,* Comment Letter of the ICI at 9-12 (Sept. 19, 1988) (File No. S7-10-88).

65 Another concern relates to the recent growth in the frequency and amount of payments made by fund advisers to broker-dealers and others distributing fund shares, a practice commonly known as "revenue sharing." Because fund advisers derive their earnings from sources including advisory fees paid by the fund, the payment of distribution expenses by advisers could involve the indirect use of fund assets to pay for distribution. Rule 12b-1 explicitly applies to direct and *indirect* financing of distribution activities. Thus, revenue sharing payments could be construed as an indirect use of fund assets for distribution that is unlawful unless made pursuant to a rule 12b-1 plan. *See supra* note 38. The Commission has historically taken the position that an adviser's financing of distribution activities would not necessarily involve an indirect use of fund assets if the payments are made from profits that are "legitimate" or "not excessive," *i.e.,* profits that are "derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the Act." *See* 1980 Adopting Release, *supra* note 23, at section titled "General Requirements." In contrast, for example, an indirect use of fund assets may result if advisory fees were increased in contemplation of distribution payments by the adviser. We are not addressing revenue sharing practices in connection with these proposals. However, we remain concerned that revenue sharing payments may give broker-dealers and other recipients incentives to market particular funds or fund classes, through "preferred lists" or otherwise, and that such incentives create conflicts of interest (*e.g.,* between a broker-dealer's suitability obligation to its customers and its self-interest in maximizing revenue) that may be inadequately disclosed. We proposed new requirements regarding disclosure of revenue sharing payments in 2004 in connection with our "Point of Sale" proposals. *See* Confirmation Requirements and Point of Sale Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26341 (Jan. 24, 2004) [69 FR 6438 (Feb. 10, 2004)]. *See also* Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26778 (Feb. 28, 2005) [70 FR 10521 (Mar. 4, 2005)] (reopening of comment period and supplemental request for comment). We are continuing to consider further rule amendments related to revenue sharing.

the then-existing NASD limits on sales loads.[66] While it does not directly regulate what funds can charge, the NASD (now FINRA) sales charge rule bars registered broker-dealers who are members from selling funds that impose combined sales charges that exceed certain limits. The limits vary based on whether the fund has a 12b-1 fee, a "service fee,"[67] rights of accumulation,[68] and other features.

Prior to 1992, the NASD sales charge rule had not been applied to rule 12b-1 fees that funds deducted from assets as a substitute for a front-end sales load. In 1992, the NASD determined that it was appropriate to amend the rule specifically to encompass *all* forms of mutual fund sales compensation, including these "asset-based sales charges."[69]

As amended, the rule caps the *annual* amount of asset-based sales charges that a fund may deduct at 75 basis points.[70] In addition, a fund with an asset-based sales charge is subject to

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[66] NASD Conduct Rule 2830(d). The NASD sales charge rule is currently administered by FINRA. FINRA derives its authority to regulate the level of mutual fund sales charges from section 22(b)(1) of the Act. *See supra* note 20. *See* Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release No. 30897 (July 7, 1992) [57 FR 30985 (July 13, 1992)] ("1992 NASD Rule Release"). In 2009, FINRA proposed to re-codify the rule, in conjunction with its consolidation of rules issued by the NASD and by the New York Stock Exchange, and to revise the rule with regard to the disclosure of cash compensation. *See* FINRA, Investment Company Securities: FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Investment Company Securities, Regulatory Notice 09-34 (June 2009).

[67] *See infra* note 152 and accompanying text for additional information on service fees.

[68] Rights of accumulation allow investors to qualify for a reduced sales charge (or "breakpoint") based on the aggregate value of shares previously purchased or owned plus the securities being purchased. NASD Conduct Rule 2830(b)(7).

[69] The NASD explained that the changes were necessary to: (i) assure a level playing field among all members selling mutual fund shares; and (ii) prevent the circumvention of its sales charge caps through the use of rule 12b-1 plans, because it had become possible for funds to use 12b-1 plans to charge investors more for distribution than could have been charged as a front-end sales load under the existing sales charge rule. *See* NASD Notice to Members 92-41; 1992 NASD Rule Release, *supra* note 66. In its comment letter, the ICI agreed that the proposed expansion of the NASD rule to include asset-based sales charges "appropriately recognizes that Rule 12b-1 fees ... alone or in combination with [CDSLs], generally serve as the functional equivalent of traditional front-end sales loads." Comment Letter of the ICI (May 10, 1991) (File No. SR-NASD-90-69).

[70] NASD Conduct Rule 2830(d)(2)(E)(i).

an *aggregate* cap of 6.25 percent of new gross sales (rising to 7.25 percent of new gross sales if the fund does not pay a service fee), plus interest, on the total sales charges levied (*e.g.*, asset-based, front-end, and deferred).[71] This aggregate cap requires a fund with an asset-based sales charge to keep a running balance from which all sales charges imposed by the fund are deducted.[72] Because it is calculated at the fund level based on the amount of aggregate new fund shares sold, the aggregate cap does not limit the actual amount of sales charges that a particular investor may pay.[73] Thus, it is possible for a long-term shareholder in a fund with an asset-based sales charge to pay more in total sales charges than would have been the case if that investor had paid a traditional front-end load.[74]

As amended, the NASD rule also places a cap of 25 basis points on the amount of a service fee that a fund may deduct annually from fund assets in order to pay intermediaries for

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71 New gross sales excludes sales from the reinvestment of distributions and exchanges of shares between investment companies in a single complex, between classes of an investment company with multiple classes of shares, or between series of a series investment company. NASD Conduct Rule 2830(d)(2)(A) and (B).

72 In effect, so long as a fund with asset-based sales charges continues to have new sales, it may never exceed the aggregate cap.

73 For convenience, in this Release we refer to the aggregate cap as a fund-level cap, but FINRA members may treat each class of shares and each series of a fund as a separate investment company for purposes of the sales charge rule and these calculations. *See* NASD Notice to Members 93-12 at n.1 (1993) ("NASD Sales Charge Rule Q&A").

74 In our statement on the proposed rule change, we acknowledged this possibility. *See* 1992 NASD Rule Release, *supra* note 66, at discussion following n.16 ("Because the proposed rule change contemplates a minimum standard of fund-level accounting rather than individual shareholder accounting, it is possible that long-term shareholders in a mutual fund that has an asset-based sales charge may pay more in total sales [charges] than they would have paid if the mutual fund did not have an asset-based sales charge."). However, we also noted that individual shareholder accounting would be permitted under the rule amendment, and encouraged its use. *See* Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release No. 29070 (April 12, 1991) [56 FR 16137 (Apr. 19, 1991)] ("NASD Notice of Proposed Rule Change") at section titled "Method of Calculating the Total Sales Charges" ("It is the NASD's intention that fund-level accounting be required at a minimum, thereby not precluding the use of more protective methods. A fund, based upon its particular circumstances and economic perspective, may choose the option of individual shareholder accounting.").

providing follow-up information and account services to clients over the course of their investment in the fund.[75] Unlike the asset-based sales charge, the service fee is not limited by an aggregate cap and, as a result, is almost always paid for an indefinite period (*i.e.,* for as long as the investor holds the shares).[76]

2. *Enhanced Disclosure*

Over the years, the Commission has taken several steps designed to improve investor understanding of 12b-1 fees and the impact they have on fund expenses and investor returns. We required funds to include a fee table in the prospectus identifying, among other things, the amount of any 12b-1 fee paid.[77] As part of the 1992 amendments to the NASD sales charge rule, we also approved a new provision prohibiting registered broker-dealers from describing funds as "no-load" funds if the funds charged 12b-1 fees greater than 25 basis points.[78] We amended our proxy rules to require funds to better describe material facts to shareholders when requesting approval of a rule 12b-1 plan or an amendment to the plan.[79] Through our Web site, we have also provided investors with information and tools designed to enhance their understanding of the fees and distribution expenses they pay as a consequence of owning mutual funds.[80]

3. *Multiple Classes*

We also permitted funds to offer multiple "classes" of shares, each with its own

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[75] NASD Conduct Rule 2830(d)(5).

[76] *See* 1992 NASD Rule Release, *supra* note 66, at section III.A.

[77] *See* Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 16244 (Feb. 1, 1988) [53 FR 3192 (Feb. 8, 1988)].

[78] *See* 1992 NASD Rule Release, *supra* note 66. *See also* NASD Conduct Rule 2830(d)(4).

[79] Amendments to Proxy Rules for Registered Investment Companies, Investment Company Act Release No. 20614 (Oct. 13, 1994) [59 FR 52689 (Oct. 19, 1994)].

[80] *See* Mutual Fund Cost Calculator (http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm).

arrangement for the payment of distribution costs and related shareholder services.[81] These multiple class arrangements were designed to give investors a choice of ways to pay for sales charges.[82] Investors in one class of shares have the same investment experience as investors in the other classes, except for expenses related to distribution and shareholder services. These multiple class arrangements have been adopted by most fund groups that sell through intermediaries.[83]

Class designations are not standardized by law, although funds often use similar nomenclature.[84] Class "A" shares generally are sold with a front-end sales load, and also often have a 12b-1 fee of about 25 basis points.[85] Class "B" shares typically are sold without a front-end load but charge a spread load consisting of a 12b-1 fee of 100 basis points (the maximum rate under NASD Conduct Rule 2830, including a service fee) and a declining CDSL.

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81 *See* Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Investment Company Act Release No. 20915 (Feb. 23, 1995) [60 FR 11876 (Mar. 2, 1995)] (adopting rule 18f-3). Rule 18f-3 contains requirements that protect the rights and obligations of each class as against all other classes, particularly with regard to shareholder voting rights, and prescribes methods for allocating income, expenses, realized gains and losses, and unrealized appreciation and depreciation among classes in a multi-class fund.

82 *See* Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds, Investment Company Act Release No. 19955, at section titled "Background" (Dec. 15, 1993) [58 FR 68074 (Dec. 23, 1993)] (stating that some funds use different classes "to offer investors a choice of methods for paying for the costs of selling fund shares"). *See also* Z. Jay. Wang, Vikram K. Nanda & Lu Zheng, *The ABCs of Mutual Funds: On the Introduction of Multiple Share Classes*, EFA 2005 Moscow Meetings Paper (Feb. 2005) (http://ssrn.com/abstract=676246); Vance P. Lesseig, D. Michael Long & Thomas I. Smythe, *Gains to Mutual Fund Sponsors Offering Multiple Share Class Funds*, 25 J. FIN. RES. 81 (2002).

83 *See* ICI, *Mutual Fund Distribution Channels and Distribution Costs* (July 2, 2003) (http://www.ici.org/pdf/per09-03.pdf).

84 The Commission staff has prepared information on mutual fund share classes, available on the Commission's Web site. *SEC, Mutual Fund Classes* (http://www.sec.gov/answers/mfclass.htm). While there are many variations, for convenience, throughout this Release we use the terms "A shares," "B shares," and "C shares" to refer to the typical share class structures, as described in the text above.

85 Class A shares may also be sold with the load waived. *See infra* note 93 and accompanying text.

Class B shares usually convert automatically to class A shares after a fixed period of time has elapsed (commonly six to eight years from the date of purchase).[86] Class "C" shares typically charge a "level load" consisting of a 100 basis point 12b-1 fee that is imposed for as long as the investor owns the shares, and also may charge a small CDSL of one percent if a shareholder redeems within the first year, but seldom convert to class A shares with lower 12b-1 fees.[87] Other classes may be available only to certain types of investors, such as those who invest in retirement plans, are institutional investors, or purchase through a particular intermediary or type of intermediary, such as a financial planner.[88]

D. The Current Role of 12b-1 Fees

Rule 12b-1 plans continue to play a significant role in paying for fund distribution costs. The majority of funds have adopted rule 12b-1 plans, which paid a total of $9.5 billion in 12b-1 fees in 2009 (down from a high of $13.3 billion in 12b-1 fees in 2007).[89]

There has been a trend in fund class share ownership away from those that impose the highest sales loads and 12b-1 fees. In recent years, no-load share classes have attracted more net

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[86] *See* 2010 ICI FACT BOOK, *supra* note 6, at 74. While there is no legal requirement for conversion, funds typically provide it. The conversion feature reflects the underlying economics of class B shares. When the underwriter recoups the commission it has advanced to the selling broker, the shareholder is considered to have paid his share of distribution costs. (If the underwriter has advanced a commission to the intermediary, it would retain 75 basis points of the 100 basis points it collects in 12b-1 fees and forward only the 25 basis points to the intermediary.)

[87] *See supra* note 84.

[88] *Id.*

[89] *See* 2010 ICI FACT BOOK, *supra* note 6, at 75. This figure excludes 12b-1 fees deducted from assets of funds underlying insurance company separate accounts offering variable annuities and mutual funds that invest primarily in other mutual funds. *See also* Comment Letter of the ICI at Appendix I (July 19, 2007) (File No. 4-538). Unless otherwise noted, references to comment letters in this Release are to letters submitted in response to the Commission's request for comments in connection with a 2007 Commission roundtable on rule 12b-1. *See* SEC Press Release, Commission Announces Roundtable Discussion Regarding Rule 12b-1 (May 29, 2007) (http://www.sec.gov/news/press/2007/2007-106.htm). These comment letters are available in File No. 4-538 (http://www.sec.gov/comments/4-538/4-538.shtml).

new cash flow than load share classes.[90] According to Investment Company Institute ("ICI") figures, in 2009, $323 billion flowed into no-load share classes of long-term mutual funds, while in comparison, load share classes only received $39 billion in net new cash flow.[91] In 2009, class B shares experienced net outflow for a seventh consecutive year, with total net outflow of approximately $24 billion.[92] In contrast, net new investment in class A shares was approximately $19 billion, and net new investment in class C shares was approximately $37 billion.[93]

Although more investors appear to be investing in no-load funds and share classes, these statistics do not reflect a trend away from using intermediaries.[94] According to the ICI, 80 percent of investors who own funds outside of a retirement plan use an intermediary that

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90 *See* 2010 ICI FACT BOOK, *supra* note 6, at 76.

91 *Id.* at 76.

92 *Id.* at 76. Net outflow from B share classes can result from purchases being exceeded by: (i) redemptions; and (ii) shares converting to another class after a certain period of time. As a result of their (typically) automatic conversion feature, B shares generally are self-limiting as a class unless they continue to be sold at the same rate as they were sold previously.

93 *Id.* at 76. Many class A shares today are sold with the load waived or substantially reduced. For example, many funds permit broker-dealers to sell their shares with the front-end load waived or substantially reduced, for use in wrap fee programs. In wrap fee programs, instead of paying a one-time sales charge for each investment purchase, a customer pays the broker an annual percentage of the assets held through that broker in exchange for the ability to buy and redeem securities without additional sales charges. According to one study, in 2008, 60 percent of class A shares were sold at NAV with the load waived. Strategic Insight Mutual Fund Research and Consulting, LLC, *Perspectives on Intermediary Sales: Trends in Fund Sales by Distribution Channel and Share Class* (May 2009). The ICI found that, although the average maximum front-end sales load on stock funds in 2009 was 5.3 percent, the average sales load actually paid by investors was only 1.0 percent, due to the impact of load-waived class A shares. *See* 2010 ICI FACT BOOK, *supra* note 6, at 65.

94 Among households owning mutual funds, only 20 percent of these investors purchased directly from mutual funds in 2009. *See* Shareholder Profile Report, *supra* note 6, at 27. The prevalence of mutual fund "supermarkets" (described in note 96, *infra*), employer-sponsored retirement plans, and fee-based financial advisers (advisers who charge investors separately for their services rather than through a load or fee assessed at the fund level) has provided investors alternative means of purchasing no-load funds. *See* 2010 ICI FACT BOOK, *supra* note 6, at 65. Many investors now purchase no-load funds through these intermediaries.

provides professional financial assistance ("financial advisor").[95] Of those investors, almost half own funds purchased solely through financial advisors, while the rest own funds purchased through financial advisors as well as directly from fund companies, mutual fund supermarkets, or discount brokers.[96] The data suggest a growing predominance of no-load or load-waived classes in funds that traditionally were sold with a load.[97] In these circumstances, investors do not pay a sales load, but pay distribution expenses through a separate fee arranged between the intermediary and the investor, and/or through the payment of ongoing "service fees."[98]

A significant use of 12b-1 fees today is for what is typically characterized as "services" provided to investors after the sale by the broker-dealers and other intermediaries who sell the fund. According to the Investment Company Institute, more than half of all 12b-1 fees paid by funds are used for this purpose,[99] with broker-dealers and bank trust departments being the primary recipients. Under the NASD sales charge rule discussed above, up to 25 basis points of fund assets annually may be paid to members as a "service fee."[100]

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95 *See* 2010 ICI FACT BOOK, *supra* note 6, at 85.

96 *Id.* at 85. Mutual fund supermarkets, which are sponsored by brokerage firms, "permit investors to purchase and hold a broad range of funds from many different fund sponsors through a single brokerage account." ROBERT C. POZEN, THE MUTUAL FUND BUSINESS (2d Ed., 2002), at 304. The primary benefit of this "one-stop shopping venue" is simplicity: an investor can buy funds from different fund families and receive all of their statements in a single report. Discount brokers allow investors to trade securities at a lower commission rate but provide less individualized service.

97 *See* 2010 ICI FACT BOOK, *supra* note 6, at 76.

98 *See generally* CAROL GEHL, ET AL., MUTUAL FUND REGULATION § 18:6.1 (May 2008); Fee Trends Report, *supra* note 22, at 6 (noting that although in the 1980s and 1990s sales loads were a primary means of compensating brokers for services provided to investors, in recent years brokers have increasingly been compensated through "asset-based" fees).

99 *See* 2010 ICI FACT BOOK, *supra* note 6, at 73.

100 NASD Conduct Rule 2830(d)(5). The NASD rule defines "service fees" as "payments by [a fund] for personal service and/or the maintenance of shareholder accounts." NASD Conduct Rule 2830(b)(9). These services could include responding to customer inquiries, providing information on investments, and reviewing customer holdings on a regular basis, but would not include sub-transfer agency services, sub-accounting services, or administrative services. *See* NASD Sales Charge Rule Q&A, *supra* note 73, at Question #17. The NASD rule does not address whether "service fees" are required

Amounts deducted from assets in excess of a service fee are typically charged to support the fund's distribution efforts and operate as an alternative to a front-end sales load.[101] These 12b-1 fees, which are used to pay the selling costs of B and C share classes, are "asset-based sales charges" under the NASD sales charge caps and are limited to a maximum of 75 basis points of fund assets, annually, as discussed above.

A common use of 12b-1 fees is to pay for the fund to be included on third-party platforms for purchasing mutual funds, such as employer-sponsored retirement plans and fund supermarkets. Supermarkets and retirement plans have become major avenues by which investors purchase mutual funds. They have assumed many of the recordkeeping and ongoing servicing and support functions for shareholders that funds otherwise would perform, and these are often paid for, at least partially, through 12b-1 fees.[102] Under the NASD sales charge rule, no-load funds are able to compensate discount brokers and supermarkets for the costs of servicing shareholders in those channels through asset-based fees of up to 25 basis points annually of the value of fund shares that are held in the intermediary's client accounts.[103] Funds

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to be included in 12b-1 plans. *Id.* at Question #25. However, we understand that funds continue to include "service fees" as distribution expenses under rule 12b-1, presumably because the stream of payments (often called "trail commissions") may act as an inducement to intermediaries' sales personnel to sell fund shares and, arguably, because fund intermediaries would provide these services in the ordinary course of business regardless of whether they receive compensation from the fund (which may be just one of many other investments held by the intermediary's clients).

[101] According to the ICI, approximately 40 percent of 12b-1 fees are used for this purpose. *See* 2010 ICI FACT BOOK, *supra* note 6, at 73.

[102] *See infra* note 153. A representative of a large fund supermarket commented at our roundtable on rule 12b-1 that some fund advisers also pay supermarket fees through revenue sharing arrangements. *See* Roundtable Transcript, *infra* note 109, at 84-87 (John Morris, Charles Schwab & Co.). *See also supra* note 65; *infra* paragraph following note 286 (requesting comment whether investors in omnibus accounts receive equivalent levels of service relative to investors in retail accounts with similar 12b-1 fees).

[103] *See* NASD Conduct Rule 2830(d)(4). Discount brokers and fund supermarkets typically hold one account with the fund in the name of the broker, and then provide sub-accounting for individual shareholder holdings of fund shares. *See* Mutual Fund Redemption Fees, Investment Company Act

that are offered as investment options in defined contribution retirement plans also may pay 12b-1 fees (often 50 basis points or more annually) to the plan administrator to offset some of the costs of servicing shareholders (and perhaps other participants) who invest through those plans.[104]

A minor use of 12b-1 fees is to pay expenses of the fund's principal underwriter and for advertising and promotions. Although this was one of the main purposes for which 12b-1 plans originally were intended, in recent years, only about two percent of 12b-1 fees have been used to pay these types of expenses.[105]

E. Additional Commission Consideration of Rule 12b-1

In 2004, the Commission amended rule 12b-1 to prohibit fund advisers from directing fund brokerage to compensate broker-dealers for selling fund shares.[106] When we proposed those amendments, we invited comment on whether the Commission should consider additional changes to the rule, including potentially rescinding it.[107] We made this request after observing

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Release No. 26782 (Mar. 11, 2005) [70 FR 13328 (Mar. 18, 2005)] at text following n.10 ("Rule 22c-2 Adopting Release").

104 *See* Comment Letter of Charles P. Nelson (June 19, 2007). Employers sponsoring defined contribution plans typically hire third-party administrators to advise them in selecting the investment options offered to employees, perform recordkeeping and administrative functions (*e.g.*, producing account statements and recording transactions), provide educational materials and seminars, and maintain call centers and Internet Web sites for use by plan participants. *See* ICI, *Mutual Fund Distribution Channels and Distribution Costs, supra* note 83.

105 *See* 2010 ICI FACT BOOK, *supra* note 6, at 73.

106 Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591 (Sept. 2, 2004) [69 FR 54728 (Sept. 9, 2004)] ("2004 Rule 12b-1 Amendments Adopting Release"). Although fund advisers may choose which brokers will execute the fund's transactions when buying and selling portfolio securities, fund brokerage is an asset of the fund. We prohibited the practice of using brokerage to reward sales of fund shares because it produces powerful incentives for advisers, is potentially harmful to fund investors, and "reliance on fund directors to police the use of fund brokerage to promote the sale of fund sales is not sufficient." *Id.* at text following n.16.

107 *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356 at section IV (Feb. 24, 2004) [69 FR 9726 (Mar. 1, 2004)] ("2004 Rule 12b-1

that the current practice of using 12b-1 fees as a substitute for a sales load was a departure from the rule as envisioned in 1980.[108]

To further explore the available options for reforming the rule, we held a roundtable on rule 12b-1 on June 19, 2007, to solicit the views of investor advocates, fund industry representatives, independent directors, current and former regulators, representatives from broker-dealers and other intermediaries who sell fund shares, and interested observers.[109] The participants responded to Commissioners' questions regarding the costs and benefits of 12b-1 plans, the role of 12b-1 plans in current fund distribution practices, and options for reform. The roundtable discussions and the nearly 1,500 comment letters we received on the topic greatly informed our understanding of the operation of rule 12b-1 and the role it plays in the distribution of mutual funds today.

Many of the panelists and commenters representing fund management companies and intermediaries contended that the rule had benefited both funds and investors in substantial ways, and that the central problem lay with the rule's outdated requirements.[110] Some of these commenters asserted that rule 12b-1 provides a cost-efficient way of paying for services that investors want and need (*i.e.*, by "mutualizing" them), including ongoing services from financial

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Amendments Proposing Release"). Comments are available in File No. S7-09-04, at http://www.sec.gov/rules/proposed/s70904.shtml.

108 *Id. See also* John A. Haslem, *Investor Learning and Mutual Fund Advertising and Distribution Fees*, J. INVESTING 53 (Winter 2009) ("Haslem") (noting "the transformation of 12b-1 fees from their original primary use for advertising and promotion" and concluding that "Rule 12b-1 fees are now used primarily to reward brokers for sales of adviser mutual fund shares").

109 *See* http://www.sec.gov/spotlight/rule12b-1.htm (which provides links to various materials relating to the rule 12b-1 roundtable). An unofficial transcript of the June 19, 2007 Rule 12b-1 Roundtable is available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf ("Roundtable Transcript").

110 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 172 (Michael Sharp, Citi Global Wealth Management); Comment Letter of the Independent Directors Council (July 19, 2007) ("IDC supports retaining the framework of Rule 12b-1 and believes that changes to the rule should take the form of enhancements and clarifications to adapt the rule to the modern world of fund distribution.").

professionals and access to funds through fund supermarkets and retirement platforms.[111] Several participants thought that investors preferred paying rule 12b-1 fees to paying front-end loads, and equated a decision to invest in a class of shares with a 12b-1 fee with a decision to pay a sales load over time.[112] They asserted that rule 12b-1 fees were, at least in part, responsible for bringing down the overall cost of investing in funds.[113]

Many of these panelists emphasized the importance of 12b-1 fees to pay for services that matter to investors.[114] They noted that platforms such as supermarkets and retirement plans use 12b-1 fees to support their service infrastructures, including interactive Web sites, investment allocation tools, and other educational materials that are currently made available to, and benefit, fund investors in those channels.[115] Several roundtable participants and commenters also noted that 12b-1 fees paid to platforms have enabled small funds and no-load funds to compete successfully for a broader segment of the investing population in many distribution channels, which is critical to their distribution strategies.[116] This development, they contended, has been beneficial because it increases competition and helps spur innovation.[117]

Other panelists were not as sanguine about rule 12b-1. They argued that even though 12b-1 fees may pay for worthwhile services to investors, the costs of those services are obscured

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[111] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 111-113 (Paul Haaga, Capital Research Management).

[112] *See, e.g.*, *id.* at 64 (Martin Byrne, Merrill Lynch).

[113] *See, e.g.*, *id.* at 171 (Michael Sharp, Citi Global Wealth Management).

[114] *See, e.g.*, *id.* at 118-19 (Joseph Russo, Advantage Financial Group); *id.* at 180 (Barbara Roper, Consumer Federation of America). Commenters also emphasized the importance of 12b-1 fees for investor servicing. *See, e.g.*, Comment Letter of the National Association of Insurance and Financial Advisors (July 13, 2007); Comment Letter of the ICI (July 19, 2007).

[115] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 218 (Don Phillips, Morningstar).

[116] *See, e.g.*, *id.* at 67 (Mellody Hobson, Ariel Capital Management) ("We could not exist without the 12b-1 fee to grow the funds.").

[117] *See, e.g.*, Comment Letter of the ICI (July 19, 2007); Comment Letter of the Securities Industry and Financial Markets Association (July 19, 2007).

in the fund's expense ratio in a way that makes the costs less transparent and the services less likely to be priced competitively.[118] They questioned the necessity of having these types of distribution charges embedded as a fund expense. In addition, they questioned whether investors are aware of and making informed choices about the services they pay for through the 12b-1 fee, which many panelists agreed lacks the prominence of a front-end load.[119] Most commenters believed that better disclosure and more effective communication of 12b-1 fees, and the manner in which they are used, would be useful to investors.[120]

One panelist argued that 12b-1 fees have the effect of increasing expense ratios and decreasing investment returns for investors.[121] Some suggested that the Commission encourage (or require) that fees to compensate distributors be paid by investors as an account charge (through "demutualization" or "externalization").[122] They argued that externalizing these "bundled costs" would make them more visible to shareholders and that unbundling costs and

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118 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 181 (Barbara Roper, Consumer Federation of America) and 185 (Richard Phillips, K&L Gates). *See also* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007); Comment Letter of Andrew Reyburn (July 20, 2007).

119 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 121 (Brad Barber, Univ. of Cal., Davis) ("And I think what you hear from the industry – and the message I hear over and over again – is that investors do not like front-end loads. There is a simple psychological reason for that. It's an in-your-face fee. When you pay a load fee, it comes immediately out and off the top. Whereas, if you pay a spread fee over time, it's less obvious and less salient."). *See also* Comment Letter of Michael R. Clancy (June 13, 2007) ("Very few if any clients actually understand the [12b-1] fee, or even know that they are paying it. Of the few who actually understand a front-end load, the overwhelming majority of those clients don't know that there is an ongoing fee as well.").

120 *See, e.g.*, Comment Letter of National Association of Personal Financial Advisors (July 17, 2007); Comment Letter of Donald H. Pratt (July 19, 2007); Comment Letter of the ICI (July 19, 2007).

121 *See* Roundtable Transcript, *supra* note 109, at 119-120 (Shannon Zimmerman, Motley Fool).

122 *See, e.g.*, *id.* at 103 (Thomas Selman, FINRA). *See also* Comment Letter of Michael R. Clancy (June 13, 2007); Comment Letter of Neil J. McCarthy, Jr. (June 19, 2007); Comment Letter of Michael Murray (June 21, 2007).

services promotes more efficient pricing of those services.[123] Representatives of fund management companies and others countered that such a fee structure already exists in the form of a mutual fund "wrap" account and other types of fee-based service arrangements that charge fees comparable to the maximum 100 basis point 12b-1 fee. They argued that it is more cost-effective and tax-efficient for funds to collect 12b-1 fees and credit the intermediaries, than it is for the intermediaries to charge their clients directly through wrap accounts.[124] As discussed above, although more investors today invest in no-load funds and share classes, this trend does not reflect the decreasing use of intermediaries, but rather the growing use of wrap accounts and other arrangements between intermediaries and investors that entail separate fees.[125]

Several participants suggested that the term "12b-1 fee" causes confusion because it encompasses so many different activities.[126] Most roundtable participants agreed that greater transparency and better communication of what 12b-1 fees are and how they are used are vital to enabling investors to make optimal choices among the alternatives offered to them.[127] Some panelists were troubled that, according to academic studies, many investors do not appear to have

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[123] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 132 (Shannon Zimmerman, Motley Fool); 204-07 (Richard M. Phillips, K&L Gates). *See also* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007) ("Mutualization of [12b-1] fees inhibits an investor from having the necessary information on price vs. value to make economic choices across service providers. This distorts fundamental, free-market economics and restricts valuable competition in the intermediary channel.").

[124] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 170-72 (Michael Sharp, Citi Global Wealth Management). *See also* Comment Letter of the ICI (July 19, 2007) ("There are significant tax and operational disadvantages to imposing 12b-1 fees at the account-level that likely would outweigh the benefits of this approach.").

[125] *See supra* text accompanying notes 97 and 98.

[126] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 58 (Paul Haaga, Capital Research Management). *See also* Comment Letter of the Independent Directors Council (July 19, 2007) ("IDC recognizes that one term may not be sufficient given the wide variety of usage of 12b-1 fees ....").

[127] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 141-54 (multiple commenters). *See also* Comment Letter of the ICI (July 19, 2007) ("Many commentators ... questioned the extent to which investors are aware of the nature and purpose of 12b-1 fees and suggested that disclosure of the fees and other distribution related costs can and should be improved. We agree.").

a strong understanding of fund fees and expenses or their impact on investment returns. In particular, some participants were concerned that, because 12b-1 fees are paid automatically in small increments over time, they are much less obvious to investors than front-end sales loads.[128] Unlike traditional loads, 12b-1 fees are deducted from fund assets, and are reflected in lower investment returns, rather than deducted directly from shareholder accounts.[129] As a result, they may not be fully appreciated as a sales charge.[130] In addition, the expanding number of share classes and the overall complexity of fund load structures can further overwhelm and confuse investors.[131]

Many roundtable participants and commenters agreed that rule 12b-1 would benefit from revision, but they differed on the best course for going forward. Many participants and

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128 *See, e.g.,* Roundtable Transcript, *supra* note 109, at 121-22 (Brad Barber, Univ. of Cal., Davis).

129 One panelist remarked that the spread load exists because "it provided a distribution channel for brokers, one that was an alternative and has many positive characteristics, but also makes the costs quite non-transparent. And I don't think that is a coincidence. The growth and use of these funds, at a time when there was a lot of press around no-load funds, I think there was a reason brokers wanted to receive their compensation for the services they provided in a way that did not allow investors to easily put a price tag on those services." *Id.* at 180-81 (Barbara Roper, Consumer Federation of America). *See also* Comment Letter of the National Association of Personal Financial Advisors (July 17, 2007) ("We believe that individual investors are confused about the purpose of 12b-1 fees and their impact upon their own returns.").

130 *See* GENERAL ACCOUNTING OFFICE ("GAO"), MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 75 (June 2000) (observing that investors are more aware of sales loads than operating expense fees, and are increasingly resistant to paying the higher front-end loads). *See also* Todd Houge and Jay Wellman, *The Use and Abuse of Mutual Fund Expenses* (Jan. 31, 2006) (academic working paper) (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880463) ("While mutual fund investors are often aware of up-front charges like sales loads, research shows they are often less cognizant of annual operating expenses, even though both types of fees are deadweight costs.").

131 *See, e.g.,* Comment Letter of Mark Freeland (June 19, 2007) ("The complexity of pricing structures makes it more difficult for the small investor to compare prices and services of different advisers."). One commenter expressed concern that the proliferation of share classes may increase costs to funds and thereby hinder shareholder returns. *See* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007) ("[T]his increase in share classes increases the fund's cost of accounting, filings, shareholder servicing (e.g., prospectus review, drafting, printing, mailing), blue sky registration, transfer agency, board review, etc. These costs are a drain to shareholder returns.").

commenters suggested that the Commission merely revise the factors for board consideration, or refashion the role of the board in overseeing 12b-1 fees, to better reflect the economic realities of fund distribution in today's market.[132] Others recommended that the Commission improve disclosure of 12b-1 fees by changing the name of the fees or, more significantly, by requiring individualized account statement disclosure of the amount of 12b-1 fees actually paid by individual shareholders.[133] Some suggested, as discussed above, that 12b-1 fees should be "externalized," that is, deducted directly from shareholder accounts rather than fund assets.[134] Finally, some commenters argued that rule 12b-1 has outlived its original purpose, and should be substantially revised or repealed.[135]

Roundtable participants generally agreed that 12b-1 fees currently are used to an extent

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[132] *See, e.g.*, Roundtable Transcript, *supra* note 109. at 50-51 (Joel Goldberg, Willkie Farr & Gallagher) and 201-02 (Mark Fetting, Legg Mason, Inc.).

[133] *See, e.g.*, *id.* at 222-23 (Avi Nachmany, Strategic Insight) and 154 (John A. Hill, Putnam Funds); Comment Letter of Access Data Corp. (July 19, 2007) (account-level disclosure of 12b-1 fees is not cost-prohibitive, and would "ensure that shareholders have full disclosure and fee transparency so that they can make an informed decision related to the fees they pay versus the services they receive."). *See also* GAO, MUTUAL FUNDS: GREATER TRANSPARENCY NEEDED IN DISCLOSURES TO INVESTORS at 54 (GAO-03-763) (June 9, 2003) (providing investors with specific dollar amounts of expenses paid or placing fee-related disclosure in quarterly account statements could increase fee transparency). *But see* Comment Letter of W. Hardy Callcott (June 18, 2007) (individualized disclosure of 12b-1 fees would entail significant costs and would not, standing alone, be meaningful to investors). We discuss the costs associated with rule 12b-1 and our proposed amendments in the Cost Benefit Analysis Section of this Release. *See infra* Section V.

[134] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 204-06 (Richard Phillips, K&L Gates); Comment Letter of CFA Institute (Aug. 9, 2004) (File No. S7-09-04) ("We also recommend that funds be required to deduct distribution-related costs directly from shareholder accounts as a separate line item, rather than from fund assets.").

[135] *See, e.g.*, Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007); Comment Letter of Lauren Garland (June 2, 2007); Comment Letter of Andrew Gross (June 9, 2007); Comment Letter of Melvyn H. Mark (June 17, 2007); Comment Letter of Michael Murray (June 21, 2007). *See also* Comment Letter of JoNell Hermanson (July 9, 2007) (stating that variable insurance products should not be permitted to charge 12b-1 fees); Comment Letter of Steve Wiands (Aug. 6, 2007) (stating that funds closed to new investors should not be permitted to charge 12b-1 fees).

and in ways that are different than originally envisioned.[136] This has caused a "disconnect" to develop between the requirements of the rule and its application. For example, roundtable participants were in general agreement that the nine "factors" that the Commission provided as guidance to the board are no longer as relevant to the current uses of 12b-1 fees. They stated that the ensuing legal uncertainties have made it more difficult for directors to perform their duties and make their required findings under the rule.[137] They also said that, although directors complete the required analysis, they tend to view 12b-1 fees as a necessity – either to recoup outlays already made or to pay intermediaries at a rate already decided by the intermediary or the marketplace – to the point that 12b-1 plans tend always to be continued from year to year.[138]

Fund directors also observed that, in many instances, they and their funds lack the bargaining power to effectively negotiate the level of fees that are paid to financial intermediaries through 12b-1 plans and other sources.[139] This is particularly true in the case of fund supermarkets, where the sponsor may charge all participating funds according to the same rate schedule. These and other statements made at the roundtable and in the comment letters suggest that one of the fundamental premises of rule 12b-1 – that independent directors would play an active part in setting distribution fees – does not reflect the current economic realities of fund distribution and the role 12b-1 fees play in it.

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[136] *See, e.g.,* Roundtable Transcript, *supra* note 109, at 192 (Richard Phillips, K&L Gates) and 194 (Mark Fetting, Legg Mason, Inc.).

[137] *See, e.g., id.* at 105 (Robert Uek, MFS Funds) and 158 (John Hill, Putnam Funds). One panelist did not view the factors as posing a significant obstacle to current distribution arrangements, however. *Id.* at 33-34 (Matthew Fink, Former President, ICI) ("The rule expressly says these factors are suggestions…So the fact that you may be approving a plan that the purported or suggested factors don't fit, it's totally irrelevant.").

[138] *See, e.g., id.* at 140 (Jeffrey Keil, Keil Fiduciary Strategies).

[139] *Cf.* Comment Letter of the Independent Directors Council (July 19, 2007) ("We are not aware of any board that has failed to renew a 12b-1 plan (or is likely to do so) ….").

III. DISCUSSION

We have carefully considered these and other views that emerged from the roundtable discussion and the many comment letters we subsequently received. Many of the letters highlighted issues that have arisen with the current operation of the rule.[140] We heard arguments advocating substantial change in how investors pay distribution costs, most of which are, at their core, arguments for greater transparency. We also heard concerns that significant changes could disrupt arrangements that are today deeply embedded in mutual fund sales and distribution networks, including those that finance the operation of fund supermarkets, retirement plan platforms, and financial planning. These arguments supported the preservation of business models that were developed around an existing regulatory framework, but tended to discount some of the more troubling aspects of distribution arrangements that affect millions of American investors. We have evaluated all of these views in developing this proposal, which is designed, as discussed further below, to enhance transparency and fairness to the benefit of investors.

We do not believe that it would benefit fund investors to return to the era in which they paid a substantial front-end sales load and did not have access to various alternative forms of distribution payment arrangements. Denying investors the ability to select alternate distribution methods or to pay for distribution services over time is not a goal of this rulemaking. Thus, we are not proposing in this rulemaking to prohibit the use of fund assets to pay sales costs. We remain concerned, however, about the conflicts of interest that arise when fund assets are used

[140] *See supra* note 89. Of the nearly 1500 comment letters we received, over 1400 were sent by financial planners and registered broker-dealers who opposed substantive reform of rule 12b-1. Of these 1400 letters, almost 1000 were form letters. *See* Comment Letter Type A; Comment Letter Type B. We received approximately 25 letters from mutual funds, large broker-dealer firms, insurance companies, industry associations, and law firms. The majority of these letters also opposed significant rule reform, but expressed various levels of support for changing the name of the fee, requiring additional disclosure, and revising the role of the fund board in approving the plan. We received approximately 10 letters from investors, most of whom supported substantive reform or repeal of the rule.

for distribution, and that fund directors monitor those conflicts. We also do not believe that merely modifying the "factors" for director consideration in order to accommodate existing industry practices would sufficiently address the issues we have identified with the use of fund assets to pay for distribution under rule 12b-1.

Therefore, we are proposing a new approach to asset-based distribution fees (*i.e.*, 12b-1 fees) that is designed to benefit fund shareholders while minimizing disruption of current arrangements. Specifically, our proposal would explicitly recognize that a portion of asset-based distribution fees (*i.e.*, asset-based sales charges) functions like a sales load that is paid over time, and thus should be subject to the requirements and limitations that apply to traditional sales loads.[141] Limits on asset-based sales charges would be applied to the amounts paid by each investor (rather than amounts paid by the fund) in order to assure that each shareholder would pay only his or her proportionate share of distribution related costs. In addition, we propose to require funds to identify for shareholders that portion of asset-based distribution fees (today's 12b-1 fees) that operates as a substitute for a sales load and thus facilitate comparison with the distribution related costs of other funds or classes of shares. The proposed new rule and rule amendments would replace current rule 12b-1.

We describe the details of our proposals in the next sections of this Release. In Section III.M of this Release, we describe the anticipated impact of these proposals on investors, fund managers and directors, broker-dealers, and other intermediaries.

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[141] We acknowledged this, at least implicitly, when we approved the NASD sales charge rule amendments in 1992. We observed that the "purpose of the revised maximum sales charge rule is to create 'approximate economic equivalency' as to the maximum sales charges for different types of mutual funds." *See* 1992 NASD Rule Release, *supra* note 66, at section V. The Commission believed the amendments would, among other things, promote fairness by assuring "some degree of parity" between the sales and sales-promotion expenses charged by traditional load classes and classes that assess 12b-1 fees. *Id.*

A. Summary of Our Proposals

The new approach we propose would, like NASD Conduct Rule 2830, differentiate between the two constituent parts of current 12b-1 fees (asset-based sales charges and service fees). Under proposed new rule 12b-2, funds could continue to use a limited amount of fund assets to pay for distribution related expenses.[142] The maximum amount of this "marketing and service fee" would be tied to the service fee limit imposed by the NASD sales charge rule (currently 25 basis points per year).[143] Unlike the service fee, however, funds could use this portion of fund assets for any distribution related expenses. This approach would serve the interests of investors and other members of the fund marketplace by providing a means of paying for participation in fund supermarkets and the maintenance of shareholder accounts, among other things, and allowing funds to support their own marketing and distribution strategies.

We also propose to permit funds to deduct from fund assets amounts *in excess of* the marketing and service fee, and we would treat these amounts as an alternative means to pay a front-end sales load. To accomplish this, we propose to amend rule 6c-10 (which permits funds to charge deferred loads) to permit this asset-based sales charge, which we would call an "ongoing sales charge." The proposed amendments in effect would treat ongoing sales charges as another form of sales load.

Our proposed amendment to rule 6c-10 would not require any special board findings (such as those required by rule 12b-1), a written plan, annual renewal, or automatic termination provisions, or impose fund governance requirements. Instead, we would apply limits on asset-based sales charges by referencing the front-end load imposed by the fund or, if none, by referencing the aggregate sales load cap imposed under the NASD sales charge rule for funds

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142 Proposed rule 12b-2(b).

143 Proposed rule 12b-2(b)(1); NASD Conduct Rule 2830(d)(5).

with an asset-based sales charge and service fee (currently 6.25 percent).[144]

These limits would be based on the cumulative amount of sales charges that an investor pays in any form (front-end, deferred, or asset-based). Under the proposed rule amendment, a fund imposing an ongoing sales charge would be required to automatically convert fund shares to a class of shares without an ongoing sales charge no later than when the investor has paid cumulative charges that approximate the amount the investor otherwise would have paid through a traditional front-end load (or, if none, the NASD rule 6.25 percent cap).[145] The proposed amendment would shift the focus of the limits from how much fund underwriters may collect in asset-based sales charges (a fund-level cap) to how much individual shareholders will pay either directly or indirectly (a shareholder account-level cap).

We are also proposing to amend rule 6c-10 to permit an alternative, elective distribution model. In this new model, intermediaries of funds could impose charges for sales of the fund's shares at negotiated rates, much like they charge commissions on sales of exchange-traded funds (ETFs)[146] and other equity securities. The proposed rule would permit fund intermediaries to charge sales loads other than those established by the fund underwriter and disclosed in the fund prospectus.

B. Rescission of Rule 12b-1

We propose, first, to rescind rule 12b-1 in its entirety.[147] As we discussed in detail above,

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144 NASD Conduct Rule 2830(d)(2)(A).

145 *See infra* note 171 and accompanying text.

146 ETFs are registered investment companies that offer public investors an undivided interest in a pool of securities. They are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day through a broker-dealer, like stocks traded on an exchange.

147 As discussed in more detail in Section III.N of this Release, we are proposing a grandfathering provision that would permit funds to deduct existing 12b-1 fees with respect to shares issued prior to

rule 12b-1 was adopted in response to a set of problems identified by the Commission in the late 1970s. But many of the assumptions underlying the rule appear to no longer reflect current marketplace realities, including the role that 12b-1 fees play in the distribution of fund shares and the tasks that directors should be required to undertake in considering whether to approve 12b-1 fees. Moreover, the rule has confounded many investors who remain unsure what a "12b-1 fee" is, how it impacts their account, and whether they should be willing to invest in a fund that imposes such a fee. Finally, the application of rule 12b-1 today reflects the confusion that has accumulated over the years as lawyers have sought to provide answers to questions that have arisen in the course of the rule's evolution.

Therefore, we have decided not to propose to amend existing rule 12b-1, but to propose a new regulatory framework to address how fund assets may be used to finance distribution costs.[148] We believe the proposed rules, as described in more detail below, would better address current investor protection concerns raised by the use of fund assets as alternatives to sales loads and as a means of financing other types of distribution costs.

We note that Regulation R under the Exchange Act,[149] which provides banks exceptions and exemptions from broker-dealer registration, specifically references fees that banks and their employees receive pursuant to plans under rule 12b-1.[150]

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the compliance date for the proposed new rule and rule amendments, which we anticipate would be at least 18 months from the effective date in the adopting release.

[148] Although we propose to rescind rule 12b-1, proposed rule 12b-2 retains the section in rule 12b-1 that restricts certain directed brokerage practices. *See* 2004 Rule 12b-1 Amendments Adopting Release, *supra* note 106. We believe that the concerns we discussed in that adopting release regarding using directed brokerage to finance the distribution of fund shares continue to apply under our new proposal, and we propose to retain the section we adopted in 2004 unchanged. *See* proposed rule 12b-2(c).

[149] 17 CFR Part 247.

[150] 17 CFR 247.721(a)(4)(iii)(A), 247.760(c).

- We have not intended that the proposed rule affect those exceptions and exemptions, and we request comment on whether further rulemaking, clarification, or interpretive guidance is necessary or appropriate in this regard.

C. Proposed Rule 12b-2: The Marketing and Service Fee

We propose a new rule 12b-2, which would permit funds, with respect to any class of fund shares, to deduct a fee of up to the NASD service fee limit (which is 25 basis points or 0.25 percent annually) from fund assets to pay for distribution activities, without being subject to the limitations on sales loads that we describe in the next section of this Release.[151] Although the fee could be used for any type of distribution cost, we anticipate it primarily would be used to pay for servicing fees of the type currently permitted by the NASD sales charge rule,[152] trail commissions to broker-dealers selling fund shares, and other expenses, such as fees paid to fund supermarkets, that may in part be distribution related.[153] This proposed rule would permit funds

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[151] Proposed rule 12b-2(b).

[152] *See* NASD Sales Charge Rule Q&A, *supra* note 73, at question 17 (explaining the types of activities for which services fees may be used).

[153] As discussed above, we have previously stated that funds may pay for non-distribution expenses under rule 12b-1 plans. *See supra* note 43 and accompanying text. Fund expenditures under current 12b-1 plans often pay for a mixture of distribution and administrative services. For example, some funds may pay their entire fund supermarket fee under a rule 12b-1 plan, even though portions of the fee may pay for administrative services that are not distribution related. A fund need not determine which portion of the fee is primarily for distribution services or which portion is primarily for administrative services, and it may be impractical and burdensome to require funds to allocate expenses. *See* Martin G. Byrne, *The Payment of Fund Supermarket Fees By Investment Companies*, 3 INVESTMENT LAW. 2 (1996) ("[B]ecause the services that are provided to a fund in a supermarket are a combination of distribution, subaccounting, administrative, account maintenance, and other shareholder services, some portion of [a supermarket fee] may be considered a payment 'primarily intended' to result in sales of a fund's shares pursuant to Rule 12b-1 .... Because a fund with a Rule 12b-1 plan is expressly permitted to pay for distribution services, it is not critical to determine whether a particular service it pays for in connection with [a supermarket fee] is or is not for distribution."). Similarly, proposed rule 12b-2 would not preclude funds from paying for these types of mixed expenses under rule 12b-2. However, to the extent that funds need not rely on proposed rule 12b-2 to charge expenses that can clearly be identified as not distribution related (*e.g.*, sub-transfer agency fees), funds could instead characterize those expenses as administrative expenses and thus keep total asset-based distribution fees within the 25 basis point limit of the marketing and service fee. *See* 1988 Release, *supra* note 28, at n.126 ("[T]o the extent a fund is paying for legitimate non-

to bear expenses similar to those that fund boards generally approved shortly after our adoption of rule 12b-1 in 1980.[154]

Unlike rule 12b-1, rule 12b-2 would not require directors to adopt or renew a "plan" or make any special findings.[155] Rather, fund boards would have the ability to authorize the use of fund assets to finance distribution activities consistent with the limits of the rule and their fiduciary obligations to the fund and fund shareholders.[156] A plan would not be required under our proposal because the proposed rules and rule amendments are structured to impose limits and safeguards on the use of fund assets for distribution, without the need for board approval of a plan. We intend that the board (including the independent directors) would oversee the amount

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distribution services, such payments need not be made under a 12b-1 plan, even if the recipient of the payments is also involved in the distribution of fund shares."). *See also supra* Section III.C of this Release. Conversely, simply characterizing an activity as "administrative" would not permit a fund to pay for it entirely outside of proposed rule 12b-2 if all or a portion of the fee is distribution related. *See, e.g.*, In the Matter of BISYS Fund Services, Inc., Investment Company Act Release No. 27500 (Sept. 26, 2006) (Commission order instituting settled administrative and cease-and-desist proceedings arising out of the improper use of fund assets for marketing and other expenses).

[154] *See supra* note 55.

[155] Some funds and fund boards have adopted so-called "defensive" rule 12b-1 plans that do not impose distribution fees on the fund, but are designed to ensure that the board and the fund do not violate the Act if fund expenditures are subsequently determined to be primarily intended to result in the sale of fund shares. *See* ICI, *Report of the Working Group on Rule 12b-1* at n.71 (May 2007) (http://www.ici.org/pdf/rpt_07_12b-1.pdf). Although 12b-1 plans (including "defensive" ones) would no longer be required to be entered into under our proposed amendments, the exemption provided by rule 12b-2 could serve the same purpose as a defensive plan to the extent that the amount of assets permitted to be used for distribution under rule 12b-2 has not otherwise been fully utilized.

[156] Section 36(a) of the Act "establishe[s] a federal standard of fiduciary duty" in dealings between a mutual fund and certain other persons, including its adviser, principal underwriter, officers and directors, among others. *See Tannenbaum v. Zeller,* 552 F.2d 402, 416 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977). Section 36(a) applies to acts or practices constituting a breach of fiduciary duty involving "personal misconduct" on the part of the person acting for or serving the fund in the enumerated capacities. This federal standard is at least as stringent as standards of care prescribed for fiduciaries under common law, such as the duty of care and the duty of loyalty. *See id.* at n.20. *See also* Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Investment Company Act Release No. 28345 (July 30, 2008) [73 FR 45646 (Aug. 6, 2008)] at section titled "Summary of Law Regarding Fiduciary Responsibilities of Investment Company Directors" (discussing state and federal law fiduciary obligations of fund directors).

and uses of these fees in the same manner that it oversees the use of fund assets to pay any other fund operating expenses, particularly those that create a potential conflict of interest for the fund's investment adviser or other affiliated persons.[157] The rule would recognize that funds bear *ongoing* expenses that, although they are distribution related, may benefit the fund and existing fund shareholders in a variety of ways. The marketing and service fee would be specifically identified and fully disclosed in the fund prospectus fee table as a type of operating expense.[158]

Funds may use the proceeds of the marketing and service fee to pay for, for example, the ongoing cost of participation on a distribution platform such as a fund supermarket, giving investors a convenient way of buying shares; for paying trail commissions to broker-dealers in recognition of the ongoing services they provide to fund investors; or for paying retirement plan administrators for the services they provide participants (and which relieve the fund from providing such services). In addition, funds (including no-load funds) may use the marketing and service fee to pay for shareholder call centers, compensation of underwriters, advertising, printing and mailing of prospectuses to other than current (*i.e.*, prospective) shareholders, and other traditional distribution activities.[159]

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[157] Congress intended that independent directors play a critical role in overseeing fund operations and protecting the interests of shareholders in view of the substantial conflicts of interest that exist between a fund and its investment adviser. *See House Hearings, supra* note 26, at 109; *Burks v. Lasker*, 441 U.S. 471 (1979). When possible conflicts are present, fund management is under a duty to fully and effectively disclose information sufficient for the independent directors to exercise informed discretion on the matters put before them. *See, e.g., Tannenbaum*, 522 F.2d at 417, citing *Fogel v. Chestnutt*, 533 F. 2d 731, 745 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976) and *Moses v. Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971).

[158] We are proposing amendments to the prospectus fee table, which are discussed in Section III.J of this Release, *infra*. We are also proposing to require funds imposing a new marketing and service fee, or increasing the rate of an existing 12b-1 fee that would be used as a marketing and service fee, to obtain the approval of their shareholders. This requirement is discussed in Section III.F of this Release, *infra*.

[159] *See* proposed rule 12b-2(b), (e).

Under the proposed rule, the marketing and service fee could not, on an annual basis, exceed the limits on service fees prescribed by the NASD sales charge rule (currently 0.25 percent of fund net assets annually). Any charge in excess of 0.25 percent per year would be considered an asset-based sales charge and subject to the overall sales load limitations established by the NASD sales charge rule and other requirements, as discussed in the next section of this Release. We chose to propose this limit because it would permit, without change, the continuation of many important uses of 12b-1 fees that may benefit investors. It also represents the line the NASD sales charge rule draws between a limited distribution fee and a sales charge – 25 basis points currently is the limit that a fund may deduct and still call itself a "no-load" fund.[160] The NASD drew upon its knowledge and expertise as the self-regulatory organization of the brokerage industry to develop these limits, which we approved as an appropriate exercise of the NASD's congressional mandate to prevent excessive sales charges on mutual fund shares.[161] Accordingly, we have used the NASD limit on service fees in formulating our proposal to distinguish a limited distribution fee from a sales charge.

We request comment on the proposal to limit the marketing and service fee to the maximum service fee permitted under the NASD sales charge rule.

- Would a different term, such as "sales/service fee," be more appropriate? If so, why?
- Would a different limit be more appropriate? Should the limit be higher (*e.g.*, 30 or

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160 Specifically, NASD Conduct Rule 2830(d)(4) prohibits any member from describing a fund as "no-load" if the fund has combined asset-based sales charges and services fees of more than 0.25 percent of average annual net assets. This provision is intended to help investors distinguish between funds that use relatively small 12b-1 fees to finance advertising and other sales promotion activities, similar to traditional no-load funds, and funds that use larger 12b-1 fees as alternatives to front-end sales loads. *See* 1992 NASD Rule Release, *supra* note 66. *See also* The Vanguard Group, *supra* note 31 (order permitting the Vanguard Group to call its funds no-load even though they made small distribution payments of 0.20% of average annual net assets).

161 *See* 1992 NASD Rule Release, *supra* note 66, at section V; 15 U.S.C. § 80a-22(b).

50 basis points) or lower (*e.g.*, 10 or 20 basis points)? If so, why? Should the limit be set with reference to the NASD rule, which would allow the NASD (now FINRA) to change the level, pending approval by the Commission?

We understand that many share classes either do not currently charge 12b-1 fees in an amount that exceeds 25 basis points, or charge none at all.[162] Many funds use these fees to compensate intermediaries for providing customers with follow-up information and account maintenance services pursuant to the NASD sales charge rule. In such cases, the shareholder service fees may in fact have a significant distribution component, which is why funds often pay them pursuant to a rule 12b-1 plan.[163] We do not propose, however, to limit the use of the marketing and service fee to these types of services (*i.e.,* those described in the NASD sales charge rule), so that funds may continue to use fund assets to pay for promotional and advertising expenses.

- Should we limit the marketing and service fee to expenses incurred for "shareholder services" as defined in the NASD sales charge rule? More generally, do investors in omnibus accounts receive equivalent levels of service relative to investors who invest directly and pay similar 12b-1 fees? Is there a disparity in service, and if so, why? What implications does this have for our proposal?

Under the proposal, "distribution activity" would be defined as "any activity that is primarily intended to result in the sale of shares issued by the fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing

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[162] *See infra* Section III.M.2 of this Release.

[163] *See* SEC, MUTUAL FUND FEES AND EXPENSES (2007) (http://www.sec.gov/answers/mffees.htm). Funds may decide that the stream of payments to a broker-dealer for providing client services (that it would have provided anyway) could be viewed as an incentive for the broker-dealer to continue selling the fund.

and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature."[164] The proposed rule does not attempt to delineate permissible distribution expenses because our experience with rule 12b-1 has shown that new distribution methods continually evolve.

- Are the identified activities appropriately considered "distribution activities"? Should we provide more guidance regarding specific expenditures that are distribution expenses and others that are not, as some commenters have suggested?[165] Should we define "distribution activity" differently? If so, how should we define it? Should funds be permitted to classify only certain expenses as marketing and service fees?[166] If so, what types of expenses?

D. Proposed Amendments to Rule 6c-10: The Ongoing Sales Charge

The proposed amendments to rule 6c-10 would permit funds to deduct asset-based distribution fees *in excess of* the amount permitted under rule 12b-2 (*i.e.*, 25 basis points annually), provided that the excess amount is considered an "ongoing sales charge" subject to the sales charge restrictions described below, including an automatic conversion feature.[167] Funds

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164 Proposed rule 12b-2(e)(2). The proposed definition of "distribution activity" is identical to the description of distribution in rule 12b-1. *See* rule 12b-1(a)(2). Because funds continually market themselves to investors, many types of activities may potentially be construed as "primarily intended" to result in fund sales. Although the definition provides flexibility, similar to rule 12b-1, distribution activities paid for through asset-based distribution fees under proposed rule 12b-2 and the proposed amendment to rule 6c-10 (as under rule 12b-1) must represent legitimate expenses of the fund. *See, e.g.*, Exemptions for Certain Registered Open-End Management Investment Companies to Impose Deferred Sales Loads, Investment Company Act Release No. 16619 at n. 3 (Nov. 2, 1988) [53 FR 45275 (Nov. 9, 1988)].

165 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 167 (Jeffrey Keil, Keil Fiduciary Strategies) ("[D]istribution expenditures should be defined in some way, shape, or form, or [the rule should] say what's not a distribution expenditure.").

166 *See, e.g.*, 2004 Rule 12b-1 Amendments Adopting Release, *supra* note 106.

167 Proposed rule 6c-10(b). We would title this section of the rule "Fund-Level Sales Charge" to distinguish it from a current provision of rule 6c-10 that provides an exemption to permit funds to deduct a "Deferred Sales Load" (*e.g.*, CDSL) (rule 6c-10(a) from shareholder accounts, and a

would not have to adopt a "plan" in order to impose an ongoing sales charge, and fund boards would not be required to make any special findings. In short, the proposed rule would treat ongoing sales charges as another form of deferred sales load.[168]

Under the proposed provision, a fund could deduct an ongoing sales charge to finance distribution activities at a rate established by the fund, provided that the cumulative amount of sales charges the investor pays on any purchase of fund shares does not exceed the amount of the highest front-end load that the investor would have paid had the investor invested in another class of shares of the same fund.[169] For example, if a fund has class A shares with a six percent front-end sales load, the fund could pay as much as six percent in total ongoing sales charges in class B shares. If another class of shares charges a front-end sales load of, for example, two percent, a total ongoing sales charge of as much as four percent could also be charged (six percent minus the two percent front-end load) with respect to that class.

We seek comment on whether the Commission should treat ongoing sales charges as a form of deferred sales load subject to the NASD sales charge limitations. We also seek comment on whether the proposed amendments to rule 6c-10, as described in more detail below, accomplish this goal.

- Do the sales charge limitations, as we propose to apply them, adequately protect investors from excessive sales loads in accordance with the objectives of section 22(b) of the Act? Would any aspect of these proposed sales charge limitations

proposed alternative that would provide an exemption from section 22(d) of the Act to permit broker-dealers to deduct "Account-Level Sales Charges" (proposed rule 6c-10(c)).

168 As a form of deferred sales load, all payments of ongoing sales charges to intermediaries would constitute transaction-based compensation. Intermediaries receiving those payments thus would need to register as broker-dealers under section 15 of the Exchange Act unless they can avail themselves of an exception or exemption from registration. Marketing and service fees paid to an intermediary may similarly require the intermediary to register under the Exchange Act.

169 Proposed rule 6c-10(b)(1).

encourage broker-dealers to recommend "switching" between fund families once an investor has reached the ongoing sale charge limits? If so, does this proposal raise any issues (that do not already exist with regard to other classes) that would encourage such switching, in light of current NASD sales charge limits? What effect could the proposed rule have on the various types of share classes currently offered by funds? For example, would funds or distributors reduce, eliminate, or increase the offering of share classes with asset-based sales charges? To the extent that broker-dealers rely on ongoing sales charges as compensation for ongoing services to investors, could the quantity or quality of the services provided change if the rule results in limits on cumulative ongoing sales charges?

1. Automatic Conversion

Under the proposed amendments, funds or fund intermediaries would not be required to keep track of the actual dollar amount of ongoing sales charges paid by each individual shareholder account (although they may choose to do so) to avoid exceeding the rule's maximum sales charge limitation.[170] A fund could satisfy the maximum sales charge limitation by providing that the shares purchased would automatically convert to another class of shares without an ongoing sales charge *no later than* the end of the month during which the fund would have paid on behalf of the investor the maximum amount of permitted sales load based on the cumulative rates charged each year.[171] In addition, a fund could impose a CDSL in combination

[170] We understand that many funds lack the ability to track dollar amounts of distribution expenses charged to purchases by individual investors.

[171] Proposed rule 6c-10(b)(1)(i) (providing that a fund may comply with the maximum sales charge limits by converting shares on or before the end of the conversion period); proposed rule 6c-10(d)(2) (defining "conversion period" as "the period beginning on the day that shares are purchased and ending on the last day of the calendar month during which the cumulative ongoing sales charge rates exceed the shareholder's maximum sales load rate"). The rule would permit conversion periods to be

with an ongoing sales charge, but total sales charges could not exceed the maximum sales charge limitation.[172]

The maximum number of months a shareholder could remain invested in a class of shares paying an ongoing sales charge would depend both on the maximum sales load and the rate of the ongoing sales charge. Thus, for example, if the maximum sales load for the fund is three percent, the ongoing sales charge could be 50 basis points annually for six years. Alternatively, the fund could collect 25 basis points annually for 12 years, 75 basis points annually for four years, 150 basis points annually for two years, and so on.

We have designed the conversion provisions of the rule so that the maximum conversion date is easily determinable at the time the investor purchases fund shares (as is a front-end sales load).[173] As a result, the fund or intermediary would be able to provide this information to an investor or a prospective investor at the time he or she makes or is considering making an

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computed as of the end of the calendar month because that would conform to the way most funds presently compute conversion periods with respect to class B shares.

Thus, for example, the provision would operate as follows: Assume that a fund offers a class A share with a 6% front-end load and no ongoing sales charge. The same fund could also offer a class of C shares with an annual ongoing sales charge of 0.75%, provided that: (i) the class C shares convert to class A shares in 96 months or earlier ([6.0% ÷ 0.75%] x 12 = 96 months or 8 years); and (ii) the class C shares do not impose any other loads.

172 Using the example in note 171, *supra,* a fund offering a class A share with a 6% front-end load could also offer a class B share that is subject to an annual ongoing sales charge of 0.75% with a declining CDSL. The maximum CDSL that the fund could charge on a purchase of class B shares would be 5.25% in the first year, 4.5% in the second year, 3.75% in the third year, and so on. At the end of the eighth year following the purchase, the fund would be required to convert the class B shares to a share class that does not charge an ongoing sales charge. Thus, regardless of when the shareholder redeems shares, the shareholder's total sales load rate would never exceed 6%, the maximum class A front-end load rate.

173 Funds could sell shares subject to a shorter conversion period than the maximum conversion period as defined under the proposed rule. In addition, funds could offer scheduled variations in the conversion period to a particular class of shareholders or transactions if the fund has satisfied the conditions in rule 22d-1. Proposed rule 6c-10(b)(1)(iii). Nothing in the rule would prevent a fund from offering to existing shareholders a new scheduled variation that would reduce the conversion period. Proposed rule 6c-10(b)(2). These provisions are similar to provisions that currently apply to deferred sales loads under rule 6c-10, and which are included in proposed rule 6c-10(a). *See* proposed rule 6c-10(a)(1)(iii) and (a)(2).

investment in the fund.[174] We propose monthly conversions because they reflect the current practices of many funds and fund transfer agents, which we anticipate would reduce costs associated with complying with the proposed rules.

- We request comment on alternatives, such as daily, weekly, or quarterly conversions.

a. Differences from NASD Cap

Our proposed *shareholder account-level cap* would effectively replace the NASD *fund-level* cap on asset-based sales charges.[175] In proposing a fund-level cap in 1991, the NASD explained that it had considered a shareholder account-level cap but, at the time, it believed that an account-level cap would require individual shareholder accounting, and in light of the difficulties involved with individual shareholder accounting, concluded that an account-level cap was not feasible.[176] The NASD acknowledged, however, that while its' approach "protects a majority of shareholders," it also "may result in a minority of long-term shareholders paying more than the maximum sales charge."[177] To illustrate, a fund shareholder paying a five percent front-end load on an investment of $10,000 in a fund will pay a $500 sales load, but the same investor investing in a fund with a (not uncommon) 12b-1 fee of 100 basis points, over a period of 10 years, could pay more than $800 in distribution related sales charges (resulting from the 75

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174 *See infra* Section III.D.1.b of this Release.

175 *See supra* Section II.C.1 of this Release.

176 *See* NASD Notice of Proposed Rule Change, *supra* note 74, at section titled "Method of Calculating the Total Sales Charges" ("Requiring the individual shareholder accounting method would mandate extensive and expensive changes in the recordkeeping methods and procedures utilized by mutual funds, would disrupt current processing of sales and redemptions, and would take several years for the industry to achieve.").

177 *Id.* The NASD considered fund-level accounting to be the "best alternative as a minimum standard at [the] time." *Id.* The NASD also noted that the industry as a whole would not be prevented from adopting "more protective methods" in the future. *Id.*

basis point asset-based sales charge component).[178] After 20 years, the difference becomes more significant: the shareholder would have paid $2292 in asset-based sales charges compared with the $500 front-end load.

The NASD's Mutual Fund Task Force, in its report on mutual fund distribution issues, expressed similar concerns when it identified limitations on the length of B share conversion periods as a potential area for regulatory reform.[179] Our proposal would address both the fairness concerns raised by the NASD Task Force in 2005 and the operational concerns raised in 1991 by avoiding the need for individual shareholder accounting. We view our proposal in many respects as the further development of the NASD sales charge rule, which was intended to bring total 12b-1 fees into "approximate economic equivalency" with traditional loads, although this equivalency would not be exact, as a result of potential varying volume discounts between share classes and differing market returns.[180]

b. Implications on Fund Operations

Our proposed account-level cap would build upon innovations of fund management companies that have developed the operational capacity to issue, track the aging of, and convert class B shares. As a result, we expect that funds and intermediaries will be able to utilize existing transfer agency and other recordkeeping systems that administer funds issuing class B shares, which we believe operate in a manner similar to the proposed conversion provision or

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178 Assuming a $10,000 initial investment and an annual return of five percent, the front-end load shareholder would have an account balance after ten years of $15,474; the shareholder in the fund with the 12b-1 fee would have an account balance of $15,162 – a deficit of $312 that is attributable to the 75 basis point asset-based sales charge component of the 12b-1 fee. Put another way, rather than paying a $500 sales load, the shareholder has paid over $800 in asset-based sales charges.

179 *See* NASD, *Report of the Mutual Fund Task Force: Mutual Fund Distribution* at 18 (2005) (http://www.finra.org/web/roups/rules-regs/documents/rules-regs?p013690.pdf).

180 *See* NASD Notice of Proposed Rule Change, *supra* note 74.

could be easily adjusted to do so.[181] In addition, we have sought to provide funds the flexibility to design different sales load structures that meet the needs of fund investors, funds, and their distribution systems. Accordingly, we do not propose to specify the annual maximum rate at which a fund could deduct annual ongoing sales charges.[182]

We request comment on the operational implications of the proposed automatic conversion.

- Can existing fund and intermediary systems be adapted so that conversion periods could be readily determined and implemented at the time of purchase? How easy or difficult would this adaptation be? How difficult would it be for funds that don't currently offer B shares to develop such systems? Is the flexibility we propose advantageous, or would a more standardized approach be more easily understood by, and in the interest of, investors? How would a more standardized approach work?

c. Implications on Transferability of Shareholder Accounts

The proposed automatic conversion feature, and its attendant requirement to track fund shares, may present additional issues when shareholder accounts are transferred between different intermediaries. We understand that, in some cases, tracking fund shares is a responsibility assumed by the fund transfer agent, in which case the portability of fund shares (*i.e.*, the ability of an investor to move his account from one intermediary to another) should not be affected. In other cases (*e.g.*, where the shares are held in omnibus accounts), fund

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181 As discussed above, funds today are selling many fewer B class shares than just a few years ago. Because systems must remain in place to meet the operational requirements of a single outstanding B class share, this trend should not affect the ability of fund management companies or their service providers to make use of existing systems to convert existing class C shares or other classes.

182 The NASD sales charge rule currently caps these fees at 75 basis points annually. However, if our proposed rule changes are adopted, the annual cap may be unnecessary because the cumulative amount of ongoing sales charges would be capped.

intermediaries track share lots and would need to provide share lot histories to the new intermediary for the new intermediary to be able to determine the remaining maximum sales charge for transferred shares.[183] We understand that fund intermediaries today have the ability to transfer share lot histories in order to: (i) service class B shares or classes with contingent deferred sales loads, and (ii) meet tax reporting requirements. Thus, we do not believe that our proposals would interfere with the ability of a shareholder to transfer shares from one intermediary to another.

We request comment on our assumptions in this area.

- Would the proposed rule's conversion requirement present any special problems when shares are transferred between customer accounts held at different intermediaries? Are there different implications with respect to different types of intermediaries and, if so, what are they? Is there any reason that some intermediaries would not be capable of transferring share lot history?[184] Are there other provisions that we should consider that would facilitate transferability?

2. *The Maximum Load*

a. <u>The Reference Load</u>

We propose that the maximum sales load that would apply to any purchase of shares in a fund class subject to an ongoing sales charge would be the highest front-end load of another class of that fund that does not charge an ongoing sales charge, and which would act as a "reference

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183 Such a transfer is unlikely to be an "offer of exchange" under section 11 of the Act, which applies only to offers by a fund or a principal underwriter of a fund. Accordingly, the "tacking" provisions of rule 11a-3 would not apply, and any aging of fund shares that a new intermediary might do would not be done to satisfy any requirement of the Act. *See infra* Section III.K of this Release.

184 We understand that some intermediaries, such as retirement plans and insurance companies, may not even track share lot history. Those situations present additional issues, which are discussed in Sections III.H and III.M.5 of this Release, *infra*.

load." [185] If a fund offers a class of A shares, the maximum amount of sales charges it could collect from an investor in B or C share classes would be the amount the investor would have paid had the investor invested in A shares with the maximum front-end load.[186] By setting the maximum front-end load, the fund, its board, and the principal underwriter would also establish the maximum amount of the cumulative ongoing sales charge.[187]

As we noted above, sales loads rarely approach the maximum of 8.5 percent permitted under the NASD sales charge rule,[188] yet we understand that rule 12b-1 fees often are charged at the maximum rate permitted, currently 100 basis points annually.[189] One reason may be that 12b-1 fees are deducted in smaller amounts, over longer periods of time, and indirectly from fund assets, and thus, to investors, they may be less salient and not as well understood when compared to front-end sales loads, and the fees themselves appear to be subject to less market

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185 Proposed rule 6c-10(d)(14)(i). In the case of shares exchanged within the same fund group, the proposed rule provides that the reference load is the highest applicable sales load of the exchanged or acquired security. Proposed rule 6c-10(d)(14)(ii).

186 Under the proposed rule, the shareholder's maximum sales load would be reduced if the shareholder previously paid a sales load on fund shares that the shareholder subsequently exchanged for shares of the current fund. Fund shareholders would also be credited for any other sales loads they paid on a particular share purchase. Thus, the maximum sales load rate that an investor could be charged would be defined under the proposed rule as the reference load minus the sum of the rates of: (i) any sales load incurred by the shareholder in connection with the purchase of fund shares, and (ii) any other sales loads or ongoing sales charges attributable to exchanged shares. Proposed rule 6c-10(d)(10). This approach is consistent with the approach the Commission has taken in implementing section 11 of the Act. Specifically, rule 11a-3 governs sales loads and other charges that may be imposed on an exchange between funds within the same fund group, and is intended to help ensure that shareholders receive credit for all sales charges incurred on a particular purchase of fund shares and are protected from the sales practice abuse of switching, *i.e.*, the practice of inducing shareholders of one fund to exchange their shares for those of a different fund solely for the purpose of exacting additional sales charges. *See* Offers of Exchange Involving Registered Open-End Investment Companies, Investment Company Act Release No. 17097 (Aug. 3, 1989) [54 FR 35177 (Aug. 24, 1989)] ("Rule 11a-3 Adopting Release"). We have also proposed conforming changes to rule 11a-3, as discussed in Section III.K of this Release, *infra*.

187 *See also infra* Section III.D.2.d.4.

188 *See* NASD Conduct Rule 2830(d)(1)(A).

189 *See supra* note 42. According to statistics compiled by our staff, 27 percent of funds that impose 12b-1 fees charge a rate of exactly 100 basis points.

pressure.[190] Thus, some of our roundtable panelists and commenters urged that the Commission "externalize" asset-based sales charges (*i.e.,* require that such charges be paid *directly* from a shareholder's account, rather than *indirectly* from fund assets) so that the amounts investors are paying would be more noticeable and transparent.[191] Our proposed approach in rule 6c-10(b) would, instead, tie the maximum amount of the ongoing sales charge to the front-end load. To the extent that competitive pressures result in funds imposing lower front-end loads, these pressures should transfer to ongoing sales charges and could result in lower charges or charges that more accurately reflect the value of the distribution services provided. In addition, this proposed approach is designed to reduce the potential that some long-term shareholders will pay a significantly disproportionate share of the distribution costs of a fund.

We request comment on the definition and function of the reference load.

- Should we establish a maximum limit on the amount of ongoing sales charge that may be deducted? Could this approach encourage funds to offer a share class with a high front-end sales load in order to charge a higher cumulative ongoing sales charge on other classes? Are the NASD rule's limits on sales charges a sufficient or appropriate guide for the reference load? The NASD sales charge limits apply at the fund level on an aggregate basis, whereas the ongoing sales charge limits of our rule proposal would apply at the level of individual accounts to limit the cumulative asset-based sales charge paid by any single investor. Should the proposed rule's reliance

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[190] *See* Brad M. Barber, Terrance Odean, and Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows,* 78 J. BUS. 2095 (Dec. 2003) (mutual fund investors are less willing to pay higher front-end loads because they are more obvious and salient, but are less sensitive to annual operating expenses, including rule 12b-1 fees).

[191] *See, e.g.,* Roundtable Transcript, *supra* note 109, at 184-85 (Richard Phillips, K&L Gates). *See infra* Section III.I of this Release regarding an alternative approach we are proposing that would permit externalized sales charges at the election of funds and their underwriters.

on the NASD sales charge limits be adjusted to take into account the difference in application? For example, would the proposal's cap have a more constraining effect on the amount of cumulative ongoing sales charges deducted by a fund? If so, should the proposal's cap be increased above the NASD cap to compensate for this? If not, what should the limits be?

- Alternatively, should we assign fund boards the responsibility of establishing the maximum amount of ongoing sales charges that a fund may deduct? If so, what standards or factors would be relevant to their determination?

b. Funds Without a Front-End Load Class

Some funds, of course, might not offer a class of shares with a front-end load, or might offer the front-end load class with asset-based distribution fees of more than 25 basis points (thus disqualifying the front-end load from acting as a reference load). We are proposing that, in these circumstances, the reference load would be the maximum sales charge permitted under NASD Conduct Rule 2830(d)(2) for funds with an asset-based sales charge and a service fee, which currently is 6.25 percent of the amount invested.[192]

We chose this rate because it is the current limit for funds with this type of sales charge structure under the NASD rule, which we approved in 1992 as not being excessive.[193] We believe linking the reference load to the NASD limits may minimize operational burdens of the amendment because funds, their underwriters, and broker-dealers are already familiar with the NASD sales charge rule limits and have structured their systems accordingly.[194] Under our

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[192] Proposed rule 6c-10(d)(14)(iii). Some funds, for example, offer only a single class of C shares. *See also* Section II.C.1 of this Release, *supra,* for a discussion of the caps under the NASD sales charge rule.

[193] *See supra* Section II.C.1 of this Release.

[194] *See supra* note 161 and accompanying text.

proposal, funds could provide for lower sales loads (through shorter conversion periods) if they wish.[195]

- We request comment on whether the rule should permit the NASD maximum sales charge of 6.25 percent to serve as a default reference load for funds that do not offer a class of shares without an ongoing sales charge. If the rule should not permit this limit, what should be the limit? We are not proposing to use the limits in the NASD sales charge rule for investment companies *without* an asset-based sales charge (as much as 8.5 percent).[196] This is because, under our proposed rule, each fund charging an ongoing sales charge by definition charges an asset-based sales charge of more than 25 basis points. Would there be any reason to designate these higher limits as a default reference load under our proposed rule amendment? We note that doing so may further extend conversion periods and, thus, the period of time that some investors may pay ongoing sales charges.
- Under our proposal, funds would be permitted to deduct total sales charges up to the maximum sales charge permitted under the NASD sales charge rule. Would our proposed use of the 6.25 percent NASD limit as a default reference load give an advantage to funds that do not offer a class of A shares? To avoid this result, should the Commission identify a "typical" maximum front-end sales load that more closely tracks current industry practice (*e.g.,* four, five or six percent) and rely on such a sales load as a default reference load when a fund does not offer a class of A shares? If so,

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195 The rule requires that, at a minimum, shares must convert *on or before* the end of the maximum conversion period. Proposed rule 6c-10(b)(1)(i). *See also supra* notes 171-173 and accompanying text.

196 NASD Conduct Rule 2830(d)(1)-(2) (describing the different sales load limits, ranging between 8.5% and 6.25%, depending on whether the fund charges an asset-based distribution fee and offers rights of accumulation and quantity discounts).

what should that default reference load be?

- We note that in recent years, the costs of trading equity securities have declined significantly.[197] In this regard, should the Commission consider proposing a rule that would establish a new limit on sales charges, in light of changes in technology and the markets?
- As an alternative, should we treat the NASD sales charge limit of 6.25 percent as the reference load for purposes of determining the maximum amount of ongoing sales charge in all cases, even if a fund has a front-end load class of shares that can serve as the reference load? Such an approach would provide economically equivalent treatment of funds that offer a class of A shares and those that do not. It would not, however, provide equivalent treatment of investors who choose to pay a front-end sales load with those that pay an ongoing sales charge. If the maximum front-end sales load is lower than 6.25 percent, shareholders in classes with an ongoing sales charge may bear a disproportionate amount of distribution costs (compared to shareholders in class A shares).

c. <u>Treatment of Scheduled Variations</u>

The proposed amendments to rule 6c-10 would not require (but would permit) funds to apply any quantity discounts or scheduled variations in the front-end load for which the investor may qualify when determining the reference load for an ongoing sales charge. Investors who pay asset-based sales charges today as a substitute for a front-end load generally are not offered

[197] *See* United States Government Accountability Office, Securities Markets: Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment, 8-29 (May 2005) (http://www.gao.gov/new.items/d05535.pdf); *see also* JAMES ANGEL, LAWRENCE HARRIS & CHESTER S. SPATT, EQUITY TRADING IN THE 21ST CENTURY, 8-13 (USC Marshall School of Business May 18, 2010) (http://ssrn.com/abstract=1584026).

any discounts or variations in the amount of fees they pay indirectly through their investment in the fund.[198] We are concerned that requiring funds and their intermediaries to calculate a different reference load for each purchase of fund shares would introduce greater cost and complexity and could affect the willingness of funds and their underwriters to offer quantity discounts or scheduled variations on front-end sales loads to investors.

We request comment on whether funds should be required to incorporate scheduled variations in the front-end load when determining a shareholder's reference load.

- How would funds likely react to this requirement if we adopted it? Would this requirement discourage funds from offering scheduled variations in the front-end load? Would it cause some funds to discontinue front-end load share classes entirely? Would it encourage funds to offer share classes with high front-end sales loads that effectively operate to increase the amount of ongoing sales charges the fund collects in other share classes?[199] How would investors react? Would this requirement affect the number of fund investors selecting the ongoing sales charge class?

d. <u>Sales Load on Asset Growth</u>

Proposed rule 6c-10(b) would operate so that a fund and its investors could determine the conversion period at the time the investor makes a purchase of shares. Each purchase (or each "lot") would have a separate conversion period, and the shares associated with each lot would be

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198 Investors nevertheless may prefer to defer the payment of sales charges rather than paying a front-end sales load in some circumstances, because a greater portion of their money is invested immediately in the fund. *See* Rule 6c-10 Proposing Release, *supra* note 57, at section titled "Discussion."

199 This could occur, for example, if a fund offered a share class with a front-end load of 8.5 percent but with scheduled variations at low investment thresholds for investors actually purchasing that class. This result may be unlikely, however, because funds would have to disclose the maximum front-end load in fund performance advertisements and use it to compute the fund's performance. *See, e.g.,* Rule 482 under the Securities Act [17 CFR 230.482], Rule 34b-1 under the Investment Company Act, and Item 26(b) of Form N-1A. *See also* NASD Conduct Rule 2210.

programmed to convert on a particular date. The maximum length of the conversion period would be unaffected by any subsequent increase or decrease in the value of the shares purchased. As a result, the fund underwriter would collect more ongoing sales charges if the value of the fund shares increased and collect less if the value decreased.[200] Shareholders would also benefit from the growth (or bear the losses) in the value of the fund shares that would not have otherwise been purchased had the shareholder paid a front-end sales load.

We believe that this approach is straightforward, is easy for investors to understand, is easy to administer, protects shareholders' interests in the allocation of risks and benefits between the shareholder and the fund's principal underwriter, and permits funds to deduct fees for distribution in the same manner that they currently deduct 12b-1 fees. This approach is different, however, from the approach currently taken by rule 6c-10 with respect to determining the maximum amount of a deferred sales load such as a CDSL.[201] Rule 6c-10(a)(1) limits the maximum amount of a deferred sales load to an amount specified at the time the shares were purchased.[202] Thus, in the case of deferred sales loads, investors never pay a higher amount as a result of fund performance.

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200 For example, assume that an investor purchased $10,000 of a class of shares with no front-end sales load and an ongoing sales charge of 0.75% with an eight-year conversion period. If the investor obtained an annual rate of return of 5%, he or she would pay $697 in ongoing sales charges over eight years and have an account balance of $13,951. If the investor received an annual return of 10%, he or she would pay $835 in ongoing sales charges and have an account balance of $20,294. If the investor received a negative annual return of -5%, he or she would pay $492 in ongoing sales charges and have an account balance of $6,227 after eight years.

201 We are also proposing to make certain non-substantive changes to the heading of current rule 6c-10, and parts of 6c-10(a), designed to clarify the names and use of the type of sales load practice discussed, including deferred, fund level, and account-level sales loads.

202 *See* 1996 Rule 6c-10 Amendments, *supra* note 58. Prior to the amendment, rule 6c-10 had required that CDSLs be based on *the lesser of* the NAV of the shares at the time of purchase or the NAV at the time of redemption. We eliminated this requirement, deferring to the NASD to address such matters in its sales charge rule. At the same time, we required that the amount of a deferred sales load not exceed a specified percentage of the NAV of the fund's shares at the time of purchase so that investors "be given the benefit, if any, of deferring the load payment should there be an increase in the shares' NAV." *Id.* at n.16 and accompanying text.

- Given that our goal is to treat asset-based sales charges the same as other deferred sales loads, should we use the same approach for both? If so, which method should be used? If we require that ongoing sales charges be based on an amount determined at the time of purchase, would funds in effect be required to track each individual shareholder dollar paid in ongoing sales charges? Should we instead propose to amend rule 6c-10 (proposed rule 6c-10(a)) to permit underwriters to collect higher deferred sales loads as a result of fund performance?

3. *Reinvestment of Dividends and Other Distributions*

The proposal would permit funds to offer to invest shares acquired pursuant to a reinvestment of dividends or other distribution in the same share class as the shares on which the dividend or distribution was declared. If the share class has an ongoing sales charge, however, the reinvested shares would have the same conversion period as the shares on which the dividend or distribution was declared.[203] As a result, reinvested shares may incur an ongoing sales charge, but would convert to a share class without an ongoing sales charge no later than the conversion date of the shares on which the dividend or distribution was declared.[204] This approach would directly benefit investors, compared to the current approach under the NASD sales charge rule (which does not limit asset-based distribution fees from being charged on reinvested dividends indefinitely), because any ongoing sales charge deducted on reinvested dividends would no longer be charged after the conversion date of the original shares. This approach also reflects what we understand to be the practice most fund groups use to account for reinvestment of distributions on class B shares, and thus would permit them to avoid incurring costs associated with revising current fund systems – costs that may ultimately be borne by fund shareholders.

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[203] *See* proposed rule 6c-10(b)(1)(ii).

[204] *Id.*

Our proposed approach would be different, however, from the NASD sales charge rule, which prohibits funds from imposing front-end sales loads and CDSLs on reinvested dividends.[205] The reinvestment of dividends does not involve the expenditure of sales-related efforts, and the NASD viewed such loads as "duplicative."[206]

- In view of the NASD rule and our intention to treat ongoing sales charges as another form of sales load, should we instead require funds to reinvest dividends and other distributions in a share class that does not have any ongoing sales charge?[207]
- We request comment on whether we should adopt the proposed approach or, alternatively, that of the NASD sales charge rule. Would there be significant costs associated with reinvesting small amounts of retail investor accounts in a different share class? If we adopt the proposed approach, should shares acquired through a dividend reinvestment plan be required to convert before, after, or at the same time as, the shares on which the dividend or distribution was declared?
- More generally, what are the prevailing market practices with regard to reinvested dividends and other distributions? What is the annual volume of dividends and distributions offered by funds, and reinvested by shareholders? What is the magnitude of fees currently paid by investors on reinvested dividends? Do funds currently offer the option for investors to reinvest dividends in other share classes?

4. *Role of Directors – Proposed Guidance*

Unlike rule 12b-1, the proposed amendments to rule 6c-10 would not impose any explicit

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205 Proposed rule 6c-10(b)(1)(ii) would address the terms under which a fund with an ongoing sales charge could reinvest dividends and other distributions in shares of a class with an ongoing sale charge.

206 NASD Notice to Members 97-48 (Aug. 1997).

207 *See* NASD Conduct Rule 2830(d)(6)(B).

responsibilities on fund boards of directors to approve (or re-approve) asset-based sales charges under the proposed rule, although we fully expect fund boards would continue to play an important role in protecting fund investors, as discussed more fully below. Directors would continue to have fiduciary duties with respect to the oversight of the use of fund assets under state law and under section 36(a) of the Act.[208] When the Commission adopted rule 12b-1 in 1980, we sought to address statutory concerns about the conflict of interest between fund advisers (who benefit from an increase in the amount of fund assets) and fund investors (who may not).[209] We were concerned about whether a fund and its shareholders would benefit from a decision to pay distribution costs from fund assets, and viewed such a decision as "a particularly difficult business judgment" that is complicated by the conflicts of interest which are present.[210] Therefore, we made these arrangements subject to the careful scrutiny of fund directors.[211] Under our proposed approach, each shareholder would pay indirectly through the deduction of ongoing sales charges by the fund only the proportionate expenses associated with the sale of his or her fund shares. When those costs are paid, the shares purchased would automatically convert to a class of shares not paying an ongoing sales charge. The fund paying an ongoing sales charge would, in a sense, operate merely as the vehicle by which the fund shareholder pays the underwriter what the investor would have paid in the form of a front-end load at the time shares were purchased. Funds and fund underwriters would have little incentive to collect ongoing sales charges at excessive rates – a class of shares paying a higher rate of ongoing sales charge would simply convert earlier to a class that does not pay an ongoing sales charge.

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208 *See supra* note 156.

209 *See* 1980 Adopting Release, *supra* note 23, at section titled "Discussion."

210 *Id.* at section titled "Independence of Directors."

211 *See* rule 12b-1(e).

We view the treatment of the ongoing sales charge as another form of sales load (together with the automatic conversion requirement) as critical in our decision not to propose a specific role for the board of directors, while addressing the underlying concerns of section 12(b) of the Act. Directors will, however, continue to have fiduciary obligations under state law and section 36(a) of the Act to consider whether use of the fund's assets to pay ongoing sales charges, within the proposed caps, is in the best interest of the fund and fund investors.[212] We expect to provide guidance in our adopting release for this proposal, to assist fund directors in satisfying their fiduciary duties.

- We request comment on the following proposed guidance.

We believe that fund directors should consider the amount of the ongoing sales charge and the purposes for which it is used according to the same procedures they use to consider and approve the amount of the fund's other sales charges in the underwriting contract under section 15(c) of the Act.[213] We further believe that directors can and should view these asset-based distribution fees as integral parts of the fund's sales load structure to which they give their assent when they annually approve the fund's underwriting contract. In determining whether to approve (or re-approve) the underwriting contract, the directors must exercise their reasonable business judgment to decide, among other things, whether the terms of the contract benefit the fund (or its relevant class) and its shareholders, whether the underwriter's compensation is fair and reasonable (considering the nature, scope and quality of the underwriting services rendered),

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212 *See also supra* note 156.

213 Section 15(c) provides, in relevant part, that "it shall be unlawful for any registered investment company … to enter into, renew, or perform any contract or agreement…whereby a person undertakes regularly to serve or act as … principal underwriter for such company unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party …."

and whether the sales loads (including the ongoing sales charge) are fair and reasonable in light of the usual and customary charges made by others for services of similar nature and quality. In evaluating the "fairness and reasonableness" of the contract, the directors should consider any factors that may be relevant, including whether the fund's distribution networks and overall structure are effective in promoting and selling fund shares given current economic and industry trends, any available breakpoints on advisory fees that may be attained from future growth in fund assets, and any economies or diseconomies of scale that may arise from continued growth of fund assets.[214]

- Is this proposed guidance appropriate? Does it provide assistance to fund directors in evaluating ongoing sales charges? Are there other factors that would be relevant to the guidance we propose to provide? Should the guidance link board approval of the principal underwriting contract to board oversight of the use of fund assets for an ongoing sales charge? If not, what standard or requirements should apply to board oversight of ongoing sales charges?
- We request comment on our proposed overall approach to refashioning the role of the board of directors in overseeing asset-based distribution fees.[215] Is there a better approach we could take? Should we retain a formal role for directors in any rule permitting funds to pay for distribution expenses from fund assets? If so, what should that role be? Should we retain the current rule 12b-1, but update the suggested factors for director consideration in order to provide directors with additional guidance? For

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[214] We understand that many fund boards currently consider these, or similar, factors when evaluating funds' underwriting contracts.

[215] Throughout this proposal we use the term "Asset-Based Distribution Fee" to mean any fee deducted from fund assets to finance distribution activities pursuant to rule 12b-2(b) (Marketing and Service Fee), rule 12b-2(d) (Grandfathered 12b-1 Shares), or rule 6c-10(b) (Ongoing Sales Charge).

example, should the factors specifically recognize that directors may consider that ongoing sales charges provide an alternative to a front-end sales load and, in that sense, benefit shareholders who choose to invest in a share class that has an ongoing sales charge? Should directors, in addition, consider whether these arrangements are structured so that individual shareholders do not bear a disproportionate share of distribution expenses? In this regard, we are particularly interested in the views of fund directors.[216]

E. Proposed Amendments to Rule 10b-10: Transaction Confirmations

Rule 10b-10 under the Securities Exchange Act requires broker-dealers to disclose specific information to their customers about securities transactions, including the price at which the transaction was effected, remuneration such as sales charges paid by the customer to the broker-dealer (if it is acting in an agency capacity), and in certain circumstances remuneration received by the broker-dealer from third parties such as a mutual fund or its affiliates.[217] The

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[216] Our proposed approach was informed by input from independent director representatives. *See* Comment Letter of the Independent Directors Council (July 19, 2007) ("IDC believes that the role of directors in overseeing 12b-1 plans should be consistent with the role of directors in overseeing front-end sales loads and fund distribution practices generally."); Letter from the Mutual Fund Directors Forum to Andrew J. Donohue, Director of the Division of Investment Management, Securities and Exchange Commission (May 2, 2008) (http://www.mfdf.com/images/uploads/resources_files/Director_Duties_MFDF_Letter_May_2_2008.pdf) ("the quarterly review of expenditures under a fund's 12b-1 plan by directors serves little purpose, particularly since directors can have little impact in the first place on 12b-1 costs incurred by funds").

[217] 17 CFR 240.10b-10. Rule 10b-10 generally requires broker-dealers that effect transactions for customers in securities, other than U.S. savings bonds or municipal securities, which are covered by Municipal Securities Rulemaking Board ("MSRB") rule G-15 (which applies to all municipal securities brokers and dealers) to provide customers with written notification, at or before the completion of each transaction, of certain basic transaction terms. This transaction confirmation must disclose, among other information: the date of the transaction; the identity, price and number of shares bought or sold (*see* 17 CFR 240.10b-10(a)(1) (the confirmation must also include either the time of the transaction or the fact that it will be furnished upon written request)); the capacity of the broker-dealer (*see* 17 CFR 240.10b-10(a)(2)); the net dollar price and yield of a debt security (*see* 17 CFR 240.10b-10(a)(5) and (6)); and, under specified circumstances, the amount of compensation paid by the customer to the broker-dealer, whether the broker-dealer is receiving any other remuneration in

Commission and its staff have taken the position, with respect to mutual fund transactions, that a broker-dealer may satisfy its rule 10b-10 obligations without providing customers with a transaction-specific document that discloses information about sales charges or third-party remuneration, so long as the customer receives a fund prospectus that adequately discloses that information.[218] Today, in connection with the other amendments we are proposing to limit cumulative sales charges and help investors make better choices when selecting a fund that imposes sales charges, we are also proposing amendments to rule 10b-10 to require disclosure of additional information on transaction confirmations in connection with transactions involving securities issued by mutual funds.[219] In addition, we are proposing to amend rule 10b-10 to

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connection with the transaction, and whether the broker-dealer receives payment for order flow (*see, e.g.*, 17 CFR 240.10b-10(a)(2)(i)(B), (C), and (D)).

The rule's requirements, portions of which have been in effect for over 60 years, provide basic investor protections by conveying information that allows investors to verify the terms of their transactions, alerts investors to potential conflicts of interest with their broker-dealers, acts as a safeguard against fraud, and provides investors a means to evaluate the costs of their transactions and the execution quality. *See* Exchange Act Release No. 34962 (Nov. 10, 1994) [59 FR 59612, 59613 (Nov. 17, 1994)].

218 *See* Exchange Act Release No. 49148 (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)] at section IV.A.2. *See also* Investment Company Institute, SEC Staff No-Action Letter (pub. avail. Apr. 18, 1979) ("ICI Letter"). In this letter, the staff of the Commission's Division of Market Regulation (now known as the Division of Trading and Markets) stated that it would not recommend enforcement action against broker-dealers that did not provide transaction-specific disclosure about mutual fund loads and related charges, so long as the customer received a prospectus that "disclosed the precise amount of the sales load or other charges or a formula that would enable the customer to calculate the precise amount of those fees." This letter reflected a position that the Commission took when it adopted rule 10b-10, when it articulated the view that, in the case of registered securities offerings, separate confirmation disclosure of third-party remuneration would be redundant if the customer received a final prospectus disclosing that information. *See* Exchange Act Release No. 13508 at n.41 (May 5, 1977) [42 FR 25318 (May 17, 1977)].

219 We proposed more comprehensive changes to the broker-dealer confirmation requirements in 2004 through proposed Exchange Act rule 15c2-2 as part of a broader initiative regarding disclosures made to investors at the time an investment decision is made. *See* Securities Exchange Act Release No. 49148, (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)]. *See also* Securities Exchange Act Release No. 51274 (Feb. 28, 2005) [70 FR 10521 (Mar. 1, 2005)] (reopening of comment period). Proposed rule 15c2-2 would have governed transactions in mutual funds, unit investment trust ("UIT") interests and 529 college savings plans, and in contrast to rule 10b-10, would have prescribed a specific form to be used for confirmation disclosure. The more targeted confirmation changes we are proposing today, unlike our earlier proposal, involve amendments to rule 10b-10 rather than a new confirmation rule

require disclosures related to callable debt securities, and to eliminate outdated transition provisions.[220]

1. Confirmation Disclosure of Sales Charges and Fees

We are proposing to amend rule 10b-10 to require confirmations to set forth information regarding front-end and deferred sales charges, as well as ongoing sales charges and marketing and service fees (as defined in proposed Investment Company Act rules 6c-10 and 12b-2) associated with transactions involving mutual fund securities.[221]

In making this proposal, we are mindful that while improving confirmation disclosure of such fees can be expected to make the confirmation a more complete record of the transaction and to promote investor understanding of the fees, customers do not receive confirmations until after completing their purchases of mutual funds; accordingly, providing for improved disclosure of cost information prior to the sale may be an additional step that we could consider to help investors make better informed investment decisions.[222]

Under the proposal, transaction confirmations for purchases of those securities would

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and confirmation form. This in part reflects comments we received on the rule 15c2-2 proposal, including commenters' concerns as to the cost of requiring a separate confirmation rule and confirmation form for certain securities. *See, e.g.,* Comment Letter of Securities Industry Association (Apr. 12, 2004) (File No. S7-06-04) ("brokerage firms would have to bifurcate what is now a single stream of confirmations, and create an entirely new stream of information for mutual fund confirmations and a different stream for all other securities transactions").

220 *See infra* Section III.E.2 of this Release.

221 The term "mutual fund security" would be defined by reference to the definition of "open-end company" in section 5(a)(1) of the Investment Company Act (15 U.S.C. 80a-5(a)(1)). While exchange-traded funds are typically organized as open-end companies, we understand that exchange-traded funds do not typically impose the sales charges or other fees that would be subject to these disclosure requirements.

222 In this regard, the staff is considering recommendations for our future consideration to enhance the information provided at the point of sale. We also note that Section 919 of the Dodd-Frank Wall Street Reform and Consumer Protection Act states "[n]otwithstanding any other provision of the securities laws, the Commission may issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor."

disclose the amount of any sales charge that the customer incurred at the time of purchase, in percentage and dollar terms, along with the net dollar amount invested in the security and the amount of any applicable breakpoint or similar threshold used to calculate the sales charge.[223] This information would be expected to help make the confirmation a more complete record of the transaction and promote investor understanding of associated costs, as well as helping customers identify any errors associated with the front-end sales charges they incur; inclusion of breakpoint information on the confirmation particularly should assist investors in conveniently identifying any breakpoint-related errors in the sales charges they incurred.[224]

Also, if the customer may pay a deferred sales charge upon redemption of the shares (such as a contingent deferred sales charge), a transaction confirmation provided to the customer at the time of purchase would disclose the maximum amount of any deferred sales charge that the customer may pay in the future.[225] The amount would be expressed as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.[226] This proposed requirement is designed to provide a customer more complete information about the deferred sales charge (which may serve as an economic substitute for the front-end sales charge)

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[223] *See* proposed new paragraph (a)(10)(i) of rule 10b-10. For purposes of these rule 10b-10 amendments, the term "sales charge" is intended to be comparable to the term "sales load," which the Investment Company Act generally defines to mean the difference between the public price of a security and the portion that is invested (less deductions for certain fees). *See* section 2(a)(35) of the Act.

[224] *See* Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003) ("Breakpoint Report") (http://www.finra.org/web/groups/industry/@ip/@issues/@bp/documents/industry/p006434.pdf) ("Confirmations should reflect the entire percentage sales load charged to each front-end load mutual fund purchase transaction. This information would enable investors to verify that the proper charge was applied.").

[225] *See* proposed rule 10b-10(a)(10)(ii).

[226] *Id.* A mutual fund could decide to calculate the deferred sales load as the lower of the net asset value at the time of purchase or at the time of redemption. Under rule 6c-10 under the Investment Company Act, a deferred sales charge may not exceed "a specified percentage of the net asset value or the offering price at the time of purchase." Rule 6c-10(a)(1).

that the customer may be obligated to pay in the future.

In addition, if, after the time of purchase, the customer will incur any ongoing sales charge or marketing and service fee, purchase confirmations would disclose the following information: the annual amount of that charge or fee, expressed as a percentage of net asset value; the aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the customer will incur the ongoing sales charge. We anticipate that this disclosure could be made relatively simply, for example: "You will pay a maximum total ongoing sales charge of 5%, deducted from the assets of the fund in which you are investing at an annual rate of 1% over the next 5 years. You also will pay marketing and service fees of 0.25% for as long as you own the fund."[227]

Confirmations further would include the following statement (which may be revised to reflect the particular charge or fee at issue): "In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you."[228] This proposal generally is intended to help make transaction disclosure more

[227] To the extent that the rate of the marketing and service fee associated with a particular mutual fund were to increase or decrease following the customer's purchase, rule 10b-10 would not require the broker-dealer to provide an updated confirmation statement to the customer. This information is typically disclosed in a supplement to a fund's prospectus filed under rule 497 under the Securities Act.

[228] *See* proposed new paragraph (a)(10)(iii)(B) of rule 10b-10. As discussed above, the term "ongoing sales charge" would be defined in proposed rule 6c-10 under the Investment Company Act of 1940, 17 CFR 270.6c-10, and the term "marketing and service fee" would be defined in proposed rule 12b-2 under that Act, 17 CFR 270.12b-2.

complete by helping to ensure that customers are informed about the use of ongoing sales charges that serve as a substitute for front-end sales charges, as well as additional uses of mutual fund assets to pay for distribution. The statement about the presence of additional charges is intended to help address the risk that confirmation disclosure of *some* ongoing charges or fees may cause some customers to wrongly infer that those charges or fees are all the ongoing costs that the customers would incur in connection with owning a mutual fund security.[229]

Finally, confirmations for transactions in which a customer redeems or sells a mutual fund security the customer owns would disclose the amount of any deferred sales charge the customer has incurred or will incur, expressed in dollars and as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.[230] This information also would be expected to help make the confirmation a more complete record of the transaction and help customers identify any errors.

We are proposing corresponding changes to the alternative periodic reporting provisions of rule 10b-10(b), which in part permit quarterly reporting for transactions involving investment company plans.[231] As revised, such periodic statements involving mutual fund security transactions would include disclosure of sales charges consistent with the proposed requirements

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229 We are not proposing to require that purchase confirmations disclose management fees or other operating expenses, as those costs are disclosed in the prospectus fee table and are not directly implicated by the transaction. We also are not proposing to specifically require that purchase confirmations disclose other categories of compensation that the broker-dealer receives in connection with the particular mutual fund being purchased, such as "revenue sharing" received from a fund's adviser.

230 *See* proposed new paragraph (a)(11) of rule 10b-10.

231 *See* rule 10b-10(b) (permitting the disclosure of transaction-related information in periodic account statements rather than in confirmations for securities purchased or sold on a periodic basis through "investment company plans"); rule 10b-10(d)(6) (defining "investment company plan" to include individual retirement or pension plans and individual contractual arrangements that provide for periodic purchases or redemptions of investment company securities).

for other confirmations.[232]

In sum, these proposed requirements are intended to help make the confirmation a more complete record of the transaction, help investors in mutual fund securities be more fully aware of the sales charges they pay, and assist investors in verifying whether they paid the correct sales charge set forth in the prospectus. In that regard, these proposed requirements seek to take into account support that commenters previously have expressed for improved confirmation disclosure of sales charges, while also taking into account commenters' concerns regarding the costs that would be associated with more extensive changes to confirmation disclosure requirements.[233] We understand that some broker-dealers may already provide disclosures about

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[232] In particular, paragraph (b)(2) of rule 10b-10, as revised, would require disclosure of "any ongoing sales charges or marketing and service fees incurred in connection with the purchase or redemption of a mutual fund security." Consistent with the proposed requirements of paragraphs (a)(10) and (a)(11), this would encompass disclosure of front-end, deferred, and ongoing sales charges.

[233] Investor advocates who commented on proposed rule 15c2-2 generally supported confirmation disclosure of costs. *See* Comment Letter of the Consumer Federation of America, Fund Democracy, Consumer Action, and the Consumers Union (Apr. 21, 2004) (File No. S7-06-04) ("Confirmation and other post-sale disclosure should quantify the costs incurred as a result of the transaction, including any costs or payments that may have been estimated in pre-sale disclosures."). More generally, the Commission also received a number of comments from the public that supported our proposals for improving disclosure. *See, e.g.,* Comment Letter of T. Booy (Mar. 16, 2004) (File No. S7-06-04); Comment Letter of R. Barndt (Mar. 15, 2004).

While securities-industry commenters generally opposed expanding the scope of confirmation disclosures in other ways (and, as noted above, stated that extensive changes to existing broker-dealer confirmation systems would be particularly expensive), a number of those commenters supported confirmation disclosure of front-end sales charges, while not supporting confirmation disclosure of ongoing costs of ownership. In the view of those commenters, confirmations fundamentally are records of transactions that are provided too late to assist investors in making decisions. *See, e.g.,* Commenter Letter of Securities Industry Association (Apr. 4, 2005) (File No. S7-06-04) (supporting confirmation disclosure of sales charges in dollar and percentage terms, which would help investors determine whether they received correct breakpoint discounts; opposing confirmation disclosure of information about ongoing fees and conflicts of interest as costly, repetitive and too late to be useful); Comment Letter of Legg Mason Wood Walker Inc (Apr. 4, 2005) (File No. S7-06-04) (opposing addition of items other than sales charge information on confirmations as duplicative and as providing information too late to be useful for investors; based on their experience, investors look to the confirmation for information about the date, amount and price of their mutual fund investments); Comment Letter of Charles Schwab & Co., Inc. (Apr. 4, 2005) (File No. S7-06-04) (supporting confirmation disclosure of transaction-specific sales fees in dollar and percentage terms; opposing disclosure on purchase confirmations of disclosure of contingent deferred sales charges, and strongly front-end sales charges in their mutual fund confirmations, in part in response to the recommendations of the Joint NASD/Industry Task Force on Breakpoints.[234]

In the event we adopt these amendments to provide for confirmation disclosure of such sales charges, we intend to withdraw a no-action letter that the Commission's staff issued to the Investment Company Institute in 1979, related to confirmation disclosure of mutual fund sales loads and related fees, as that letter would no longer be consistent with the rule.[235]

We request comment on all aspects of these proposals, including the following:

- Would the information we propose to include in transaction confirmations be useful to investors? Would confirmation disclosure of quantified information about ongoing sales charges and marketing and service fees, without quantified information of other ongoing costs associated with owning mutual funds, imply that no other ongoing fees would be associated with their purchase? Would it imply that other ongoing fees are smaller or otherwise less important? If so, should confirmations also set forth the percentage amount of other ongoing expenses, including, but not limited to: (a) other shareholder fees, as disclosed in the mutual fund prospectus fee table pursuant to Item 3 of Form N-1A; (b) management fees, as disclosed in the mutual fund prospectus fee table pursuant to Item 3 of Form N-1A; and (c) any other expenses, disclosed in the mutual fund prospectus fee table pursuant to Item 3 of Form N-1A?
- Conversely, given that marketing and service fees (unlike ongoing sales charges) would not act as economic substitutes for front-end sales charges, should we amend

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opposing confirmation disclosure of comprehensive annual costs and of conflict of interest information).

234 *See* Breakpoint Report, *supra* note 224.

235 *See* ICI Letter, *supra* note 218; *see also* Breakpoint Report, supra note 224 ("In connection with this recommendation, the Task Force also recommends that the SEC staff revisit its April 18, 1979 No-Action Letter, which permits the omission of sales charge information from confirmations.")

rule 10b-10 to require disclosure of quantified information about marketing and service fees? Could requiring confirmation disclosure of marketing and service fees lead to disparate disclosure to the extent that mutual funds follow disparate practices with regard to whether they use the proceeds of marketing and service fees to pay for certain types of services?

- Would the statement set forth in proposed rule 10b-10 (a)(10)(iii)(B) be sufficient to put investors on notice that they will be subject to additional costs over and above the disclosed front-end, deferred and ongoing charges and fees? Alternatively, should such ongoing fees be disclosed in some document other than the transaction confirmation? For example, would the account statement required by self-regulatory organization ("SRO") rules[236] be a more appropriate document for disclosures of ongoing costs, or for information about the source and amount of broker-dealer remuneration in connection with the mutual fund?
- Would it be helpful to investors to require disclosure of front-end and deferred sales charges in dollar terms? Would limiting the disclosure to percentage terms be a cost-effective way of permitting customers to check the terms of the transaction? Would it be helpful to investors to require that confirmations for mutual fund purchase transactions set forth the maximum amount of any deferred sales charge that the customer may incur upon redeeming the mutual fund?[237]
- Should rule 10b-10 also specify the format and presentation of how such cost and fee information should be disclosed (*e.g.*, specifically requiring that such information be

236 *See* NASD Conduct Rule 2340 (Customer Account Statements).

237 FINRA rules currently require broker-dealers to include the following disclosure in transaction confirmations for investment company purchases: "On selling your shares, you may pay a sales charge. For the charge and other fees, see the prospectus." *See* NASD Conduct Rule 2830(n).

highlighted on the confirmation, or placed in the front of a confirmation if a paper-based confirmation is used, or be subject to a minimum font size)?

- Should transaction confirmations – or some other document – seek to quantify the total amount of front-end, ongoing and deferred fees the specific investor may expect to incur over time under reasonable assumptions; if so, how could such an "all in" fee be presented most effectively?
- Should purchase confirmations for mutual funds also be specifically required to set forth quantified information about the source and amount of all remuneration that the broker-dealer directly or indirectly receives in connection with the mutual fund, including, for example, "revenue sharing" received from a fund's adviser?
- In addition, we request comment on whether the proposed disclosures should be applicable to transactions in other securities that may carry sales charges, such as UIT interests, real estate investment trust interests or direct participation plan interests. Commenters particularly are asked to address any disclosure issues that are particular to each of those products; UIT interests, for example, may carry a combination of initial sales charges, deferred sales charges (deducted in periodic installments) and so-called "creation and development" fees. To the extent these amendments are applicable to UIT interests, would special provisions be needed to address transactions involving variable insurance products?
- We further request comment on whether the proposed requirement for disclosure of front-end sales charges also should require disclosure of equivalent costs (*i.e.*, the difference between the public price and the resulting amount invested) incurred in connection with purchases made during primary offerings of closed-end funds. In

addition, we request comment on whether the confirmation requirements of rule 10b-10 should be revised to encompass transactions in 529 college savings plan interests, which, as municipal securities, currently are excluded from the application of rule 10b-10.

2. *Additional Changes to the Confirmation Rule*

In addition to proposing confirmation rule changes in connection with our proposed replacement of rule 12b-1 with a new regulatory scheme, we are also proposing to amend rule 10b-10 to require disclosure of the first date on which certain debt securities may be called.[238] Disclosure of the first date upon which a debt security may be called will provide customers with meaningful information that is intended to help avoid any confusion for investors who are not otherwise aware that a bond may be called on a date earlier than the one specified on the confirmation. In particular, the rule as revised would require disclosure of the first date on which the security may be called when a broker-dealer effects a transaction in a debt security on the basis of yield-to-call.[239] Currently, the rule requires a broker-dealer that had effected a transaction in a debt security on the basis of yield-to-call to disclose, among other information, the type of call, the call date, and the call price. A bond may be subject to call on a series of dates; as a result, although a confirmation may have stated what the bond's yield-to-call would be if the bond is called on one of those dates, the confirmation may not have informed a customer about the first possible date on which a bond is subject to call. That may confuse

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[238] This proposal is consistent with proposed amendments to rule 10b-10 that we made in 2004 in conjunction with proposed rule 15c2-12. *See* note 219, *supra*. We received no comments on this aspect of the proposal. At that time, we also proposed to amend rule 10b-10 to require broker-dealers that effect transactions in callable preferred stock to disclose to their customers that the stock may be repurchased at the election of the issuer and that additional information is available upon request. We are not reproposing that amendment at this time, but will continue to consider the need for such a requirement.

[239] *See* proposed paragraph (a)(6)(i) of rule 10b-10.

investors who are not otherwise aware that a bond may be called on a date earlier than the one specified on the confirmation. The possibility of earlier call can subject the investor to additional reinvestment risk, because the investor may have worse alternatives for reinvesting the proceeds if the issuer calls the security when prevailing interest rates decline.

- We request comment on whether this proposal would provide useful information to investors.

Finally, we propose to delete paragraph (e)(2) of rule 10b-10, which sets forth transitional provisions related to confirmation requirements for security futures products, and which expired in 2003.[240]

- We request comment on this technical amendment.

F. Shareholder Approval

Marketing and Service Fee. Under proposed new rule 12b-2, a fund would be required to obtain the approval of a majority of its shareholders before it could institute, or increase the rate of, a marketing and service fee.[241] However, shareholder approval would not be required for a fund to institute a marketing and service fee with respect to a new class of fund shares, allowing a fund to institute (or increase) a marketing and service fee and apply it only to investments in the new class and avoid the cost of soliciting proxies to obtain shareholder approval.[242]

An existing shareholder in a share class that institutes a marketing and service fee may have invested in reliance on disclosure that the fund does not charge such fees or charges them at a lower rate. In order to avoid paying new marketing and service fees, the shareholder's only

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240 Consistent with that deletion, we also propose to redesignate paragraphs (e)(1)(i) through (e)(1)(iv) as paragraphs (e)(1) through (e)(4).

241 *See* proposed rule 12b-2(b)(2).

242 Under the proposed rule, shareholder approval would only be necessary with respect to the class or series affected by the fee increase.

recourse would be to redeem his shares and risk incurring significant additional costs, including potential capital gains taxes. Less vigilant investors may only discover new marketing and service fees after paying them for some time. Thus, we believe that these charges should not be imposed or increased without shareholder approval.[243]

For similar reasons, rule 12b-1 currently requires shareholder approval when a 12b-1 plan is adopted or is amended to increase materially the amount to be spent for distribution,[244] and thus in this regard our proposal would not significantly change the rights of fund shareholders or the obligations of funds and fund underwriters. Fund directors would not (as discussed above) be specifically required by the rule to approve the fees, although fund directors may determine to solicit proxies in support of (or in opposition to) the imposition of the fee or an increase in the fee.

Ongoing Sales Charge. Ongoing sales charges would be treated differently, however. Under the proposed amendments to rule 6c-10, a fund would not be permitted to institute, or increase the rate of, an ongoing sales charge, or lengthen the period before shares automatically convert to another class of shares that does not incur an ongoing sales charge, after any public offering of the fund's voting shares or the sale of such shares to persons who are not organizers of the fund.[245] A new fund (*i.e.*, a fund that has not made a public offering), or an existing fund with respect to a new class of shares, would not need to obtain shareholder approval before instituting a marketing and service fee or an ongoing sales charge (because no shareholders that

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[243] *See* section 1(b)(1) of the Act, which provides, in relevant part, that "the national public interest and the interest of investors are adversely affected — (1) when investors purchase...securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities ...."

[244] Rules 12b-1(b)(1) and (b)(4).

[245] *See* proposed rule 6c-10(b)(3).

are not affiliated with the fund's sponsor would be affected).[246] However, after the fund or class has been sold to the public, an ongoing sales charge would not be permitted to be instituted or raised with regard to that fund or class.

We believe that ongoing sales charges should not be instituted or increased in existing funds, or lengthened in duration, regardless of shareholder approval. The current regulatory framework does not allow for sales charges to be retroactively imposed or increased with regard to prior investments, and we believe that permitting increases in ongoing sales charges in existing share classes would negatively impact investors. Shareholders may select a fund in part based on the level of the ongoing sales charge, if any, and the level of services they received from the intermediary receiving the ongoing sales charge. Under the proposed rules, an institution or increase of an ongoing sales charge after a shareholder has agreed to pay a defined cumulative ongoing sales charge would be akin to retroactively renegotiating the terms of the contract without the explicit consent of the particular shareholder affected.

We request comment on the shareholder approval requirements.

- Should we require shareholder approval to institute or increase a marketing and service fee? Would permitting funds to institute, increase, or lengthen the period of ongoing sales charges negatively impact investors? Should we permit shareholder approval to institute, or increase the rate of, an ongoing sales charge, or lengthen the period before shares automatically convert to another class of shares that does not incur an ongoing sales charge? Should the rule specify who should bear the cost of soliciting shareholder proxies to approve or increase the rate of an asset-based

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[246] Similar to rule 12b-1, a fund would not be required to obtain shareholder approval for marketing and service fees or ongoing sales charges that are implemented prior to the sale of fund shares to the public. Rule 12b-1(b)(1). *See also supra* note 41.

distribution fee? If so, should the fund or the fund underwriter bear the cost?

G. Application to Funds of Funds

We propose provisions in both rules 12b-2 and 6c-10 that would address asset-based distribution fees that could be deducted when one fund (the "acquiring fund") invests in shares of another (the "acquired fund"). Section 12(d)(1)(A) of the Act, our rules, and the NASD sales charge rule currently include provisions that restrict the layering of sales loads, asset-based sales charges and service fees in so called fund of funds arrangements, in which one investment company invests in the shares of another.[247] As described further below, we would include

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[247] Section 12(d)(1)(A) of the Act prohibits a registered investment company (and any investment companies it controls) from: (i) acquiring more than 3 percent of the outstanding voting securities of any other investment company; (ii) investing more than 5 percent of its total assets in any one acquired investment company; or (iii) investing more than 10 percent of its total assets in all acquired investment companies. Section 12(d)(1)(B) prohibits a registered open-end investment company (*i.e.* an acquired fund) from: selling securities to any acquiring investment company if, after the sale the acquiring investment company (together with investment companies it controls) would (i) own more than 3 percent of the acquired fund's outstanding voting securities or (ii) together with other acquiring investment companies (and investment companies they control) own more than 10 percent of the acquired fund's outstanding voting securities. Section 12(d)(1)(F) of the Act provides an exemption from the limitations of section 12(d)(1) that allows a registered investment company to invest all its assets in other investment companies if, among other things, the sales load charged on the acquiring investment company's shares is no greater than 1.5 percent. Rule 12d1-3 allows acquiring investment companies relying on section 12(d)(1)(F) to charge sales loads greater than 1.5 percent provided that the sales charges and service fees charged with respect to the acquiring investment company's securities do not exceed the limits of the NASD sales charge rule applicable to funds of funds. Rule 12d1-3(a). The NASD sales charge rule requires funds of funds to aggregate sales charges and services fees paid by both the acquiring and acquired funds in complying with its limits. *See* NASD Conduct Rule 2830(d)(3).

Section 12(d)(1)(G) provides a similar exemption that permits a registered open-end fund or UIT to acquire an unlimited amount of shares of registered open-end funds and UITs that are part of the same "group of investment companies" as the acquiring fund. The provision is available only if either: (i) the acquiring fund does not pay (and is not assessed) sales loads or distribution related fees on securities of the acquired fund (unless the acquiring fund does not itself charge sales loads or distribution related fees); or (ii) the aggregate sales loads or distribution related fees charged by the acquiring fund on its securities, when aggregated with any sales load and distribution related fees paid by the acquiring fund on acquired fund securities, are not excessive under rules adopted under section 22(b) or 22(c) of the Act by a securities association registered under section 15A of the Exchange Act, or the Commission. The NASD has adopted limits on sales loads and distribution related fees applicable to funds as well as to funds of funds. *See* NASD Conduct Rule 2830. *See also* Section II.C.1 of this Release.

similar provisions to restrict the layering of marketing and service fees and ongoing sales charges in the amendments we are today proposing.

1. Marketing and Service Fee

Proposed rule 12b-2 would permit both an acquiring fund and an acquired fund in a fund of funds arrangement to charge a marketing and service fee, as long as the total of the fees charged by the funds together does not exceed the NASD service fee limit (25 basis points).[248] Thus, under proposed rule 12b-2(b)(2), if an acquiring fund deducts a marketing and service fee of 10 basis points, it would be limited to investing in other funds that deduct a marketing and service fee of no more than 15 basis points. This is the same approach as that taken by the NASD sales charge rule, which limits a fund of funds to a combined service fee of 25 basis points, and which limits a fund of funds that wishes to hold itself out as a no-load fund to combined service fees and asset-based sales charges (12b-1 fees) of 25 basis points.[249]

We request comment on our approach to applying rule 12b-2 to fund of funds

Under the NASD sales charge rule's provision for funds of funds, if neither the acquiring nor acquired investment company has an asset-based sales charge (12b-1 fee), the maximum aggregate sales load that can be charged on sales of acquiring investment company and acquired investment company shares cannot exceed 8.5 percent (or 7.25 percent if the company pays a service fee). *See* NASD Sales Charge Rule 2830(d)(3)(A). Any acquiring or acquired investment company that has an asset-based sales charge must individually comply with the sales charge limitations on investment companies with an asset-based sales charge, provided, among other conditions, that if both companies have an asset-based sales charge, the maximum aggregate asset-based sales charge cannot exceed 75 basis points per year of the average annual net assets of both companies; and the maximum aggregate sales load may not exceed 7.25 percent of the amount invested (or 6.25 percent if either company pays a service fee). *See* NASD Conduct Rule 2830(d)(3)(B). The rule is designed so that cumulative charges for sales related expenses, no matter how they are imposed, are subject to equivalent limitations. *See* 1992 NASD Rule Release, *supra* note 66, at text accompanying n.9. *See also* NASD Notice to Members 99-103 (Dec. 1999) (http://www.finra.org/RulesRegulation/NoticestoMembers/1999NoticestoMembers/P004026) ("We have amended the [sales charge rule] to ensure that, if both levels of funds in a fund of funds structure impose sales charges, the combined sales charges do not exceed the maximum percentage limits currently contained in the rule.").

248 Proposed rule 12b-2(b)(2).

249 NASD Conduct Rule 2830(d)(3)(C).

arrangements.

- Should we, instead, preclude either acquiring funds or acquired funds from charging a marketing and service fee rather than cumulating the amounts? In the case of an acquiring fund investing in multiple acquired funds charging different marketing and service fee rates, should the rule's limits apply to the weighted average of the marketing and service fees rather than the maximum fee?[250] Would this be feasible? If so, how often should the acquiring fund determine such a weighted average for purposes of complying with the limits on marketing and service fees in proposed rule 12b-2? What other methods could be used to ensure that shareholders in funds of funds do not pay excessive fees under proposed rule 12b-2?

2. *Ongoing Sales Charges*

We are also proposing that an acquiring fund and an acquired fund could not *both* charge an ongoing sales charge. Under proposed rule 6c-10(b)(1)(iv), an acquiring fund that relies on the rule to deduct an ongoing sales charge could not acquire the securities of another fund that imposed an ongoing sales charge.[251] An acquiring fund that did not charge an ongoing sales charge would not be subject to this restriction and would therefore be free to invest in funds imposing an ongoing sales charge.

We understand that the classes of shares of most acquired funds do not carry 12b-1 fees or, if they do, carry a 12b-1 fee of less than 25 basis points. We also understand that when funds

[250] *See* proposed rule 12b-2(b)(2). We understand that the NASD sales charge rule's limits on cumulative service fees and asset-based sales charges (for no-load funds) does not permit weighted averaging, and thus applies the maximum rate as would our proposed rule. *See* NASD Conduct Rule 2830(d)(3).

[251] An acquiring fund would determine its ongoing sales charge as the amount it deducts from fund assets in excess of *its* marketing and service fee, without regard to any acquired fund's marketing and service fee. Proposed rule 6c-10(d)(11).

do acquire shares of other funds with a sales load or 12b-1 fee, they often do not charge loads or 12b-1 fees themselves.[252] Thus, if our proposal were adopted, we do not expect that it would affect the structure or operation of most funds of funds.

- We request comment on our understanding, and how our proposal would affect funds of funds.

Our approach to applying proposed rule 6c-10(b) to funds of funds is not the same as the approach taken by the NASD sales charge rule, which permits asset-based sales charges at both levels but requires the rates to be accumulated in determining compliance with the relevant limits.[253] We have not taken this approach because it would involve substantial complexities when an acquiring fund invests in (and over time purchases and sells) multiple acquired funds (with different ongoing sales charges) that would have to be factored into the length of conversion periods that would be required by proposed rule 6c-10(b).

- We request comment on this proposed approach. We request that commenters who favor an approach that would require accumulating of ongoing sales charges (rather than restricting ongoing sales charges on either the acquiring or acquired fund), address how accumulation might work in a way that is not unduly complicated.

H. Application to Funds Underlying Separate Accounts

Our proposed rule and rule amendments would apply to funds that serve as investment vehicles for insurance company separate accounts that offer variable annuities or life insurance

[252] *See, e.g.,* New Century Portfolios, Prospectus at 18 (http://www.newcenturyportfolios.com/Documents/Prospectus%203.01.09%20-%20New%20Century%20Portfolios%20Final.pdf) (acquiring funds do not charge a sales load, and 12b-1 fees for the five series range from 0.10% to 0.22%).

[253] NASD Rule 2830(d)(3)(B)(ii).

contracts.[254] Separate accounts are typically organized as unit investment trusts.[255] They invest the proceeds of premium payments made by contract owners in one or more mutual funds (underlying funds) that manage the assets that support the insurance contracts.

Owners of variable insurance contracts may pay substantial distribution costs[256] in the form of a front-end load, a contingent deferred load, or ongoing charges that are deducted from the assets held by the separate account, or a combination of these charges.[257] In addition, directors of some underlying funds have approved adoption of rule 12b-1 plans to support various distribution and shareholder servicing activities.[258] We understand that in most cases these charges do not exceed 25 basis points annually.

Under our proposed rule changes, underlying funds would be treated like other mutual funds. Thus, an underlying fund could charge a marketing and service fee up to the NASD sales

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[254] *See* section 2(a)(37) of the Act (defining "separate account").

[255] *See* section (4)(2) of the Act (defining "unit investment trust"). *See, e.g.*, Wendell M. Faria, Variable Annuities & Variable Life Ins. Reg. § 3:4.2 (Dec. 2009) ("[P]ractically all separate accounts are organized as unit investment trusts under a two-tier structure in which the separate account invests in an affiliated or unaffiliated underlying fund (or funds) organized as an open-end management investment company.").

[256] The FINRA sales charge rules do not place a maximum sales charge limitation on variable contracts. *See* NASD Notice to Members 99-103; Order Granting Approval of and Notice of Filing and Order Granting Accelerated Approval of Amendments Nos. 4, 5, and 6 to the Proposed Rule Change Relating to Sales Charges and Prospectus Disclosure for Mutual Funds and Variable Contracts, Exchange Act Release No. 42043 (Oct. 20, 1999) [64 FR 58112 (Oct. 28, 1999)] (approving NASD rule change eliminating maximum sales charge limitations on variable contracts). Until 1996, section 27 of the Act effectively limited the amount of the sales load that could be charged on a variable contract. When Congress enacted the National Securities Market Improvement Act of 1996, it amended section 27 to provide an exemption for variable contracts. Pub. L. No. 104-290 (1996).

[257] *See* Goldberg and Bressler, *supra* note 52, at n.28 ("While variable insurance products, like mutual funds, did not pay distribution fees prior to the adoption of rule 12b-1, they paid mortality and expense charges. These provided a source of revenue to reimburse the insurance company for the portion of the sales commission not covered by a CDSL.").

[258] *See* Comment Letter of Sutherland, Asbill & Brennan, on behalf of the Committee of Annuity Insurers (July 19, 2007) (similar to traditional mutual funds, underlying funds charge 12b-1 fees to support activities such as promoting underlying funds to prospective contract owners, printing underlying fund prospectuses, and training and educating agents).

charge rule limit on service fees. Asset-based distribution fees in excess of the marketing and service fee would be deemed ongoing sales charges and subject to the requirements of the proposed amendments to rule 6c-10. Like other mutual funds, in order to impose an ongoing sales charge under proposed rule 6c-10(b), an underlying fund (or the insurance company sponsor) would have to keep track of share lots attributable to contract owner purchase payments, and provide for the automatic conversion of shares by the end of the conversion period. We understand that insurance company separate accounts may not currently track and age shares because they generally do not offer underlying funds with contingent deferred sales loads. Under our proposal, insurance companies would either have to develop this capability or offer only shares of classes that do not impose an ongoing sales charge.[259]

We request comment on whether we should treat underlying funds differently than other funds.

- Given that most distribution activities occur at the separate account-level, is it appropriate to permit underlying funds to impose the marketing and service fee or ongoing sales charges?[260] How would these fees be used? Should we limit underlying funds to the marketing and service fee? Should we consider some other structure for limiting fees charged by underlying funds?

I. Proposed Amendments to Rule 6c-10: Account-Level Sales Charge

We are also proposing to amend rule 6c-10 to provide funds with an alternative approach

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[259] We discuss this issue as it arises in the context of retirement plans in Section III.M.5 of this Release, *infra*. We discuss the potential costs of implementing a conversion feature in Section IV of this Release, *infra*.

[260] *See, e.g.*, Comment Letter of JoNell Hermanson (July 9, 2007) (urging elimination of 12b-1 fees for variable products because "12b-1 fees have become a 'shell game' for insurance companies and have allowed them to camouflage their profit margin as investment management fees.").

to distributing fund shares through dealers if the fund so chooses.[261] Under the proposed elective provision, a fund (or a class of the fund) could issue shares at net asset value (*i.e.*, without a sales load) and dealers could impose their own sales charges based on their own schedules and in light of the value investors place on the dealer's services. In effect, this exemption would allow the unbundling of the sales charge components of distribution from the price of fund shares, similar to the existing ETF distribution model. The proposed rule amendment is, among other things, designed to provide flexibility to fund underwriters and dealers, encourage price competition among dealers offering mutual funds and, ultimately, benefit fund investors.

1. Section 22(d): Retail Price Maintenance

Section 22(d) of the Investment Company Act prohibits mutual funds, their principal underwriters, and dealers from selling mutual fund shares to the public except at a current public offering price as described in their prospectus. Because mutual fund sales loads are part of the selling price of the shares,[262] this provision essentially fixes the price at which mutual fund shares may be sold because all dealers in a fund's shares must sell shares at the same sales load disclosed in the prospectus.[263] By requiring that all dealers sell shares of a particular fund to the public only at uniform prices as established by the fund, section 22(d) effectively prohibits

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[261] Proposed rule 6c-10(c).

[262] *See also* section 2(a)(35) of the Act (defining "sales load" to mean "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer (or in the case of a unit investment trust, by the depositor or trustee), less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities").

[263] *See* Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Release No. 13183 (Apr. 22, 1983) [48 FR 19887 (May 3, 1983)] ("Rule 22d-1 Proposing Release") ("This section effectively prohibits price competition in sales loads on mutual fund shares at the retail level.").

competition in sales loads on mutual fund shares at the retail level.[264]

Our rules have provided limited exemptions from this provision, for example, by permitting funds to establish "scheduled variations" in sales loads that allow for volume discounts, although the amount and terms of these discounts must be uniform and set forth in their prospectuses.[265] Section 22(d) continues, however, to preclude dealers from competing with each other by establishing their own pricing schedules or negotiating different terms with their customers. Dealers may offer their customers a choice of alternate funds with differing sales loads; they may not, however, offer discounts on sales loads established by the funds whose shares they sell.

In enacting section 22(d) as part of the original Act in 1940, Congress gave funds authority to control their distribution to a degree denied most commercial enterprises by the federal antitrust laws.[266] The reasons Congress might have had to achieve such a result are unclear, due to the paucity of legislative history or other clear indications about Congress's intent

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[264] By its terms, section 22(d) only applies to principal underwriters and dealers in fund shares and does not apply to brokers. *See United States v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 715 (1975). The securities laws draw a distinction between dealers and brokers. Generally, a dealer buys and sells securities for its own account as part of a regular business; a broker acts as an agent by matching buy and sell orders between other investors. The same intermediary may act as either a broker or a dealer, depending upon the transaction. *See* 15 U.S.C. § 78a-3(a)(4), (a)(5); 15 U.S.C. § 80a-2(a)(6), (a)(11). Although section 22(d) only applies to principal underwriters and dealers in fund shares, funds also are able to maintain control over their distribution networks through share transfer restrictions permitted under section 22(f) of the Act. *See National Ass'n of Sec. Dealers, Inc.*, 422 U.S. at 729.

[265] *See* rule 22d-1; Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Release No. 14390 (Feb. 22, 1985) [50 FR 7909 (Feb. 27, 1985)]. We have also provided an exemption from section 22(d) for certain insurance company separate accounts, and in other circumstances. *See, e.g.*, rule 22d-2 under the Act.

[266] *See* the Sherman and Clayton Acts, 15 U.S.C. § 1-7; 15 U.S.C. § 12-27; 29 U.S.C. § 52, 53. Although such restrictions on price competition would normally be a violation of the antitrust laws, section 22(d) provides antitrust immunity for such restrictions. *See National Ass'n of Sec. Dealers, Inc.*, 422 U.S. at 701 ("... §22(d) of the Investment Company Act requires broker-dealers to maintain a uniform price in sales in this primary market to all purchasers except the fund, its underwriter, and other dealers. And in view of this express requirement, no question exists that antitrust immunity must be afforded these sales.").

when it adopted the provision.[267] Section 22(d) has been the subject of considerable debate because it tends to restrict rather than foster competition. Some, including roundtable participants and commenters, have identified section 22(d) as inhibiting competition and contributing to high distribution charges.[268]

Commenters have suggested a number of rationales for the enactment of section 22(d), including: (i) eliminating certain "riskless" trading practices by fund insiders; (ii) preserving an orderly distribution of mutual fund shares; and (iii) protecting shareholders from price discrimination.[269] Regulatory and marketplace developments that have occurred since 1940, however, have addressed the rationales that have been attributed to section 22(d). The Commission addressed the harms of riskless trading abuse in 1968 when it adopted rule 22c-1, which requires the "forward pricing" of mutual fund shares.[270] The Supreme Court also found in

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267 *See, e.g.,* Rule 22d-1 Proposing Release, *supra* note 263 ("[T]here is relatively little in the Act's legislative history to explain the purpose of section 22(d) ….").

268 *See, e.g.,* Comment Letter of the Consumer Federation of America, *et al.*, (May 10, 2004) (File No. S7-09-04) ("The reality, however, is that while competition flourishes, that competition does not necessarily serve to benefit investors. In fact, in the broker-sold portion of the market, funds compete to be sold, not bought. When funds compete to be bought, they compete by offering a good product and good service at a reasonable price. When funds compete to be sold, they do so by offering generous financial incentives to the sales force. Far from benefiting investors, this reverse competition tends to drive costs up, not down, and it allows mediocre high-cost funds to survive, and even thrive. The primary reason investors are being denied the benefits of competition is the legal requirement that funds set the compensation that brokers are paid for the services that those brokers provide to the investor."); Roundtable Transcript, *supra* note 109, at 103 (Thomas Selman, FINRA) ("One [area in need of revisiting] is 22(d), the retail price maintenance provision in the '40 Act, which, for example, prohibits a broker-dealer from simply charging its own commission for the sale of a fund at NAV, like they would a stock. There is no reason, really, why that restriction still should be in place.").

269 *See* Rule 22d-1 Proposing Release, *supra* note 263 at text accompanying nn.5-8.

270 *See id.*, at section 1.b; Adoption of Rule 22c–1 under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase, and Amendment of Rule 17a–3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders, Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (Nov. 7, 1968)]. Rule 22c-1 requires that mutual fund purchases and redemptions be executed at the price next computed after receipt of the order. *See* rule 22c-1(a). The execution of transactions at prices *previously* computed (which had been permitted in the past) thus

1975 that section 22(f) of the Act permits funds to manage any secondary market in fund shares and preserve an orderly distribution system.[271] Finally, as we noted in 1983 in connection with a rule proposal under section 22(d), the concern of unjust price discrimination among purchasers has been substantially dispelled by the results achieved from the unfixing of brokerage commission rates in 1975 after our adoption of rule 19b-3 under the Securities Exchange Act of 1934.[272] That rule prohibits national securities exchanges from requiring members to charge fixed brokerage commissions, and market experience after the rule showed that commission rates fell into rational patterns that reflect the sales costs involved and the services provided.[273]

As discussed in detail below, we are proposing an elective account-level sales charge alternative that would exempt certain funds from the requirements of section 22(d). We are proposing this account-level sales charge alternative pursuant to section 6(c) of the Act, which provides broad authority for the Commission to exempt any class of persons, securities, or transactions from the Act to the extent that such an exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."[274] For the reasons discussed in this section and below, we

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would violate rule 22c-1, in addition to other applicable provisions such as anti-fraud provisions. *See, e.g., In the Matter of Charles Schwab & Co., Inc.*, Investment Company Act Release No. 26595 (Sept. 14, 2004) (settlement of a case where a broker-dealer permitted certain favored clients to submit "substitute" mutual fund trades past the 4 pm fund pricing deadline).

[271] *See* United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975).

[272] *See* Rule 22d-1 Proposing Release, *supra* note 263, at section 1.b of Discussion.

[273] *See id.*; Charles M. Jones & Paul J. Seguin, Transaction Costs and Price Volatility: Evidence from Commission Deregulation, 87 AMER. ECON. REV. 728, 730 (1997) ("Evidence from Commission Deregulation").

[274] 15 U.S.C § 80a-6(c). In addition to the authority granted us by section 6(c), section 22(d)(iii) of the Act provides an exception from retail price maintenance for sales made "in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12." We are also proposing the account-level sales charge alternative pursuant to our authority in section 22(d)(iii), although for ease of reference we have included the proposed provision in rule 6c-10.

anticipate that this proposed approach would expand the range of distribution models available to mutual funds, enhance transparency of costs to investors, promote greater price competition, and provide a new alternative means for investors to purchase fund shares at potentially lower costs. Thus, we believe that the account-level sales charge approach we are proposing today would be necessary and appropriate in the public interest, and is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

2. *Account-Level Sales Charges*

Proposed rule 6c-10(c) would permit a fund in certain circumstances to offer its shares or a class of its shares at a price other than the current public offering price stated in the prospectus. A fund class could offer shares to dealers who would then be free to establish and collect their own commissions or other types of sales charges to pay for distribution. The amount of these fees (and the times at which they would be collected) would not be governed by the Act.[275] Thus, for example, this fee could be paid directly by the investor or could be charged to the investor's brokerage account, depending on the arrangement between the intermediary and investor. The intermediary could charge this fee at the time of sale, over time, or upon redemption.

This type of sales load arrangement would be similar to the "externalized sales charge" concept on which we requested comment in 2004,[276] and which was discussed extensively at our

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[275] Intermediaries registered with FINRA would continue to be subject to existing limits on excessive compensation under NASD Conduct Rules 2830 and 2440.

[276] *See* 2004 Rule 12b-1 Amendments Proposing Release, *supra* note 107. In particular, we asked comment on one approach of refashioning rule 12b-1 to provide that funds deduct distribution related costs directly from shareholder accounts rather than from fund assets. We received over 1700 comment letters in response to the release's request for comment, many of which presented alternatives and suggestions that warranted additional review. We deferred proposing any further changes at that time. *See* 2004 Rule 12b-1 Amendments Adopting Release, *supra* note 106, at section II.C.

2007 12b-1 roundtable.[277] In light of the many concerns raised by commenters, we are not proposing to require funds to externalize their distribution expenses.[278] Rather, we propose to make this available as an option for funds that so elect. The commissions or fees charged by the dealers to their customers could be determined in the same manner as commissions and fees charged on other types of financial products.[279]

We believe this alternative approach to distribution may be attractive to dealers, funds, and fund shareholders. Dealers offering an array of funds from different fund groups could sell each fund to their customers according to a single price schedule, which could take into consideration the volume of transactions with that dealer (rather than the size of the purchase of shares of the particular fund), the level and type of services provided, and the type of fund offered. Currently, investors pay the same costs for distribution when purchasing a fund, regardless of the quality or type of services provided by a dealer. Under our proposal, if the

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277 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 103 (Thomas Selman, FINRA), 157, 165 (John Hill, Putnam Funds), 204-07 (Richard Phillips, K&L Gates), and 207-13 (Avi Nachmany, Strategic Insight; Barbara Roper, Consumer Federation of America).

278 Among other issues, commenters were concerned that requiring all funds to externalize their distribution systems would result in high transition costs, significant disruptions to current distribution systems, higher distribution costs for small investors, and adverse tax consequences. *See, e.g.*, Comment Letter of the ICI (May 10, 2004) (File No. S7-09-04); Comment Letter of the Financial Planning Association (May 10, 2004) (File No. S7-09-04). *See also* Roundtable Transcript, *supra* note 109, at 207-209 (Avi Nachmany, Strategic Insight). *But see id.* at 207 (Richard Phillips, K&L Gates). Some commenters objected to our requiring externalized distribution fees because they assumed that externalization would force shareholders to liquidate fund shares to pay the fees, which would cause investors to realize capital gains (or losses). *See, e.g.*, Comment Letter of Terry Curnes (May 3, 2004) (File No. S7-09-04); Comment Letter of Legg Mason, Inc. (May 10, 2004) (File No. S7-09-04). In most cases, however, intermediary-sold funds are held in accounts that have alternative sources of cash to pay distribution fees, *e.g.*, interests in a money market fund, the use of which would not result in adverse tax consequences to investors. *See* EGON GUTTMAN, 28 MODERN SECURITIES TRANSFERS § 4:15 (3d ed. 2009).

279 The antitrust immunity provided by section 22(d) for the fund's other distribution channels, if any, would not be disturbed by this proposed exemption. *See, e.g.*, Rule 22d-1 Proposing Release, *supra* note 263 ("Since the proposed rule would exempt investment companies, principal underwriters, and dealers only to the extent and under such conditions as determined by the Commission to be consistent with the protection of investors, in the Commission's view, existing antitrust immunity afforded by section 22(d) would not be affected by the proposed rule.").

dealer and the fund elect to permit it, investors would be able to choose the level of dealer services they want and pay only for their chosen services. Investors might, for example, choose low-cost, low-service plans; high-cost, high-service plans; or something in between that better matches their preferences.

Such an approach could also simplify the operations of the dealer, which could process transactions based on a single, uniform fee structure. Such a structure could eliminate or reduce the need to educate employees (*e.g.,* broker-dealer representatives) on the myriad distribution arrangements offered in today's market, and help avoid mistakes that may harm customers and expose the dealer to liability when employees make errors.[280] And it could eliminate (or at least ameliorate) dealer conflicts that may lead them (or their employees) to recommend funds to customers based on the amount of the compensation received from selling the funds, rather than on the customer's needs.[281]

An externalized fee structure may appeal to some fund groups as well, including small

[280] On occasion, the complexity and variety of sales load arrangements has contributed to the failure of some intermediaries to provide their customers with the breakpoints to which they were entitled. REPORT OF THE JOINT NASD/INDUSTRY TASK FORCE ON BREAKPOINTS at 7 (July 2003) (http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p006434.pdf) ("Thus, a broker-dealer that sells funds offered by multiple mutual fund families must understand the aggregation opportunities offered by each fund family in order to deliver all appropriate breakpoint discounts to its customers. As broker-dealers increase the number of fund families whose funds they offer, fulfilling the obligation to understand the aggregation opportunities becomes an increasingly complex and burdensome task."). Another example of the difficulties that can arise from a multiplicity of differing fund policies and fees was brought to our attention when a number of intermediaries commenting on the redemption fee rule supported a uniform redemption fee as a means of eliminating the complexity associated with these fees. *See* Rule 22c-2 Adopting Release, *supra* note 103, at text following n.93.

[281] *See, e.g.,* REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES at 7 (Apr. 10, 1995) (http://www.sec.gov/news/studies/bkrcomp.txt) ("Some product sales or transactions offer much higher commission payouts to [registered representatives] than others. $10,000 invested in the typical front-end 'load' stock mutual fund, for instance, produces over twice as much immediate commission revenue to the registered representative as an equal amount invested in exchange-listed stocks."). *See also* Ruth Simon, *Why Good Brokers Sell Bad Funds*, MONEY, July 1991 (http://money.cnn.com/magazines/moneymag/moneymag_archive/1991/07/01/86657/index.htm).

funds and new entrants to the market that are eager to attract dealers that wish to sell shares based on their own fee schedules. Funds that choose to sell their shares only through an externalized fee structure could significantly simplify their operations and shorten their prospectuses by eliminating the need for multiple classes of shares.

Fund investors may benefit from buying funds through dealers that entered into these distribution arrangements in several ways. By reducing conflicts for dealers, these arrangements would reduce the risk that investors would be placed in funds that are not suitable for their particular circumstances. Sales charges would be more transparent and could be imposed or deducted in a manner and at a time that is most attractive to the investor.[282] Investors may be able to negotiate lower loads with their dealers by, for example, forgoing some of the services that they would otherwise pay for with the distribution charges, or by engaging in a substantial amount of business with the dealer (although not necessarily with the particular fund or fund family). Moreover, externalized fee structures may permit investors to invest in dealer-sold funds without purchasing associated (and unwanted) services. If negotiable account-level sales charges are accepted by market participants, increased competition among dealers may result in lower overall distribution costs or more attractive services for investors.[283]

Externalized fee arrangements are currently used in a number of other contexts and thus appear to be operationally feasible. For example, separately managed accounts and wrap

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[282] Some participants in our roundtable identified disadvantageous tax consequences as a reason for retaining asset-based sales charges rather than externalized sales charges. *See, e.g.,* Roundtable Transcript, *supra* note 109, 208-09 (Avi Nachmany, Strategic Insight). Under the proposed approach, however, investors purchasing through intermediaries could select a method of payment that would yield the best after-tax result for them.

[283] *See* Comment Letter of Bridgeway Funds, Inc., and Bridgeway Capital Management (July 19, 2007); *see also* Hannah Glover, *Schwab Slashes ETF Expenses in Challenge to Vanguard, BlackRock*, IGNITES (June 15, 2010) (noting that ETF distribution model, which similarly permits the unbundling of the sales charge components of distribution from fund shares, has seen steady decreases in fees and commissions).

accounts operate on an externalized distribution model.[284] In each case, at least part of the distribution costs is paid out of the assets of the account. As discussed above, recent years have seen the growing predominance of wrap accounts and other arrangements that entail separate fees paid by investors to intermediaries.[285] Some of the roundtable participants expressed concern that current externalized fee arrangements in other contexts (*e.g.* separately managed accounts and wrap accounts) tended to have higher rather than lower fees than mutual funds and thus may be disadvantageous to smaller investors.[286]

- Should this be of concern to us as we consider this rulemaking? Are those higher charges related to additional services and features that these products and accounts provide, and therefore not comparable to the externalized sales charge alternative we are proposing?

We request comment on the advantages and disadvantages of allowing an externalized alternative distribution model.

- Would fund investors benefit from this distribution model? If so, how would they benefit or otherwise be affected? Are there significant drawbacks to investors to permitting this distribution model and, if so, what are they? What competitive or anti-competitive effects could result from such a model? Would our proposed alternative distribution model allow investors to effectively choose among dealers for

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284 *See, e.g.,* Roundtable Transcript, *supra* note 109, at 76-78 (Martin Byrne, Merrill Lynch).

285 *See supra* text preceding notes 97 and 98.

286 *See, e.g.,* Roundtable Transcript, *supra* note 109. at 207-13 (Avi Nachmany, Strategic Insight; Barbara Roper, Consumer Federation of America). *See also* Comment Letter of the ICI (July 19, 2007); Comment Letter of Gary Roth (June 13, 2007); Comment Letter of Rick Sany (June 13, 2007). *But see* Comment Letter of Mark Freeland (June 19, 2007) ("But why should a mutual fund wrap account cost more if it is only providing the same level of service? Moreover, if the levels of service are indeed different, couldn't advisers create another tier of service for a lower fee, much as mutual fund wrap accounts typically charge less than equity wrap accounts?").

the right balance of price and service when buying mutual funds? How else might the availability of this distribution model affect investor behavior? We are interested in hearing from retirement plan administrators and trustees whether this distribution alternative might offer the beneficiaries of the plans increased transparency.

- We request comment on whether the availability of a class of fund shares that does not carry fixed distribution charges would increase competition among dealers and lead to lower sales charges for investors. Since 1975, when we abolished fixed brokerage commission rates, the cost of brokerage has decreased significantly for both institutional and retail brokerage customers.[287] Could we expect a similar result for fund investors if we permit retail price competition for at least some classes of shares of mutual funds?
- How would other market participants react to our proposed exemption? Would fund managers take advantage of this distribution model? Would competition among funds for the interest of dealers induce fund managers to offer a class of shares permitting dealers to control distribution pricing? Would discount broker-dealers begin offering funds that had previously been sold only through "full-service" brokers? Would "full-service" broker-dealers begin offering a class of the same shares at lower cost to their customers who, for example, bought and sold funds without the assistance of their representatives? Would dealers view our proposed exemption as providing an alternative that would help them reduce complexities and conflicts in selling fund shares? Would the exemption help reduce conflicts of interest by permitting dealers to eliminate differences in compensation and thus

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[287] *See, e.g.*, Evidence from Commission Deregulation, *supra* note 273.

encouraging recommendations based solely on the best interests of their customers? If many funds rely on the proposed rule, what would be the effects on distribution arrangements, and on distributors that do not rely upon the rule?

3. *Account-Level Sales Charges: Terms of Proposed Rule 6c-10(c)*

The account-level sales charge alternative would be available to any fund with respect to all of its shares, or any class of its shares.[288] As we discussed above, the exemption is optional, and funds may choose not to take advantage of it and continue to distribute their shares only with sales charges established by the fund.

In order for a fund to rely on the section 22(d) exemption provided in proposed rule 6c-10(c), it would have to meet two conditions. First, the fund (with respect to that share class) would not be permitted to impose an ongoing sales charge as defined in proposed amendments to rule 6c-10.[289] We are proposing the account-level sales charge as an alternative to an ongoing sales charge rather than as a supplement to it. The fund could, however, charge a marketing and service fee pursuant to proposed rule 12b-2.[290] Second, the fund would have to disclose in its registration statement that it has elected to rely on the exemption, which would allow interested investors the ability to better understand the distribution structure of the fund.[291] A fund relying on proposed rule 6c-10(c) would be permitted to use the marketing and service fee to support the fund's marketing and sales efforts, including advertising, sales material, and call centers, while permitting dealers to collect loads, fees, and other account-based charges to support the dealers' sales assistance and other services provided to its customers.

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288 Proposed rule 6c-10(c).

289 Proposed rule 6c-10(c)(1).

290 *See* proposed rule 12b-2(b).

291 *See* proposed rule 6c-10(c)(2). The disclosure would appear in the fund's Statement of Additional Information ("SAI"). *See* proposed Item 25(d) of Form N-1A.

We request comment on all aspects of proposed rule 6c-10(c).

- Should we require that each fund class charge a marketing and service fee in order to rely on proposed rule 6c-10(c), or should a fund instead be able to offer a class of its shares in reliance on rule 6c-10(c) without charging such a fee? Alternatively, as we have proposed, should proposed rule 6c-10(c) be available to all funds, regardless of whether they use fund assets to finance distribution pursuant to proposed rule 12b-2? We also request comment on the condition that the fund class not deduct an ongoing sales charge pursuant to proposed rule 6c-10(b). Are there any circumstances under which a fund should be permitted to rely on the exemption under proposed rule 6c-10(b) *and* charge an ongoing sales charge under proposed rule 6c-10(c)?
- We request specific comment on whether the fund's election to rely on proposed rule 6c-10(c) should be disclosed anywhere other than the registration statement. We also request comment on where the fund's election should appear in the registration statement. As proposed, the election would be disclosed in the fund's Statement of Additional Information.[292] Should it appear in the fund's prospectus or summary prospectus? Should the fund's board be required to make or specifically approve the election?
- Are any other conditions appropriate? Should we limit the exemption to funds that sell their shares to dealers at net asset value? Are there any additional benefits or problems associated with proposed rule 6c-10(c)?
- We also request comment on the interaction between proposed rule 6c-10(c) and the other amendments we are proposing in this Release. For example, if the Commission

[292] Proposed Item 25(d) of Form N-1A.

does not adopt proposed rule 12b-2, proposed rule 6c-10(b) or the proposed rescission of rule 12b-1, should it nevertheless adopt proposed rule 6c-10(c)? Is any of the rationale that supports the Commission's adoption of rule 6c-10(c) diminished (or augmented) if the Commission does not adopt any of the other amendments it is today proposing?

J. Amendments to Improve Disclosure to Investors

We are proposing several amendments to our disclosure requirements to improve the transparency of sales loads and asset-based distribution fees. The amendments, which reflect the new approach we are proposing with respect to asset-based distribution fees, are designed to improve investors' understanding of the distribution related charges they would directly and indirectly incur as a result of investing in a fund.

1. Amendments to Form N-1A

Form N-1A is the registration form used by funds to register with the Commission under the Securities Act and the Investment Company Act. Item 3 of Form N-1A sets forth the requirements for the prospectus "fee table," which lists all fund expenses.[293] Rule 12b-1 fees

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[293] We recently amended Form N-1A to require key information to appear in plain English in a standardized order in mutual fund prospectuses, including information about the fund's investment objectives and strategies, risks, costs, and performance. In the same release, we also amended rule 498 under the Securities Act to allow a fund to satisfy its prospectus delivery obligations under section 5(b)(2) of the Securities Act by providing the summary prospectus, if the full statutory prospectus is available on an Internet Web site. *See* Enhanced Disclosure and New Prospectus for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28584 (Jan. 13, 2009) [74 FR 4546 (Jan. 26, 2009)] ("Summary Prospectus Adopting Release"). In the proposing release for the summary prospectus, we requested comment as to whether we should consider other revisions to the headings in the fee table to make them more understandable to investors, including eliminating the term 12b-1. *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28064 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)] ("Summary Prospectus Proposing Release"). However, in the Summary Prospectus Adopting Release, we concluded that it was more appropriate to consider these changes in the context of a full reconsideration of sales charges and rule 12b-1. *See* Summary Prospectus Adopting Release at text accompanying n.126.

currently are disclosed as a fund operating expense under the heading "Distribution [and/or Service] (12b-1) Fees."[294]

The reference in the current fee table to "12b-1 fees" is not, of course, consistent with the new regulatory approach we are proposing for asset-based distribution fees. Moreover, the current fee table may not present the fee most effectively. Many of our roundtable panelists, as well as a number of commenters on our summary prospectus rule, agreed that reference to an SEC rule number is not informative.[295]

To address these concerns, we are proposing to amend the fee table requirements to separate asset-based distribution fees into two component fees. Specifically, we propose to delete the current heading, and replace it with the heading "Ongoing Sales Charge," which would be the ongoing sales charge we are proposing today. This line item would continue to appear in the lower portion of the fee table which relates to the expenses that shareholders pay indirectly as a result of holding an investment in the fund, expressed as a percentage of net asset value.[296] We would also add a new subheading to the "Other Expenses" category called "Marketing and Service Fee."[297] Funds would include each of these line items in their fee tables only if they

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294 *See* Item 3 of Form N-1A.

295 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 106 (Bob Uek, MFS Funds). *See also* Comment Letter of The Honorable Donald Manzullo (Feb. 28, 2006) (File No. S7-28-07) ("In keeping with the idea of simplified disclosures, a preferential way to begin would be by re-naming the fees altogether, as the name '12b-1' is esoteric, at best.").

296 The percentage of the maximum front-end and deferred sales loads would continue to be presented in the upper part of the fee table related to fees that are paid directly by shareholders upon entry to or exit from the fund.

297 The fee table currently requires funds to disclose separately only two types of operating expenses – management fees (the fee paid to the investment adviser) and 12b-1 fees. The rest of a fund's operating expenses are included under the caption "other expenses." The instructions permit funds to subdivide this caption into no more than three sub-captions that identify the largest expense or expenses comprising "other expenses," but the fund must include a total of all "other expenses." *See* Instruction 3(c) to Item 3 of Form N-1A.

charge the relevant fee.[298]

The new heading and subheading correspond to our treatment of these charges under the new rule and rule amendments we are proposing today,[299] and are designed to more clearly describe the fees to investors.[300] In particular, the "Ongoing Sales Charge" heading should better convey to investors that this portion of the asset-based distribution fee operates as a substitute for a sales load. When this heading is used in a prospectus offering multiple classes with adjacent fee tables, investors may be more likely to understand the nature of the alternatives available to them. We view greater investor understanding of this fee as an important goal of this rulemaking, and expect that it would lead to more informed decisions by investors when selecting among funds and fund share classes.

Today, some funds may pay for certain services (*e.g.,* sub-accounting fees to a retirement plan administrator) in the form of a "rule 12b-1 fee," while others pay for the same service as an ordinary fund operating expense and account for the expense as "other expenses" in the operating expenses portion of the current fee table.[301] Similarly, under our proposed approach, some funds are likely to treat expenses for the same service as a "marketing and service fee" or "other expenses." Different approaches to the same fees do not affect the comparability of fund

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298 Instruction 1(c) to Item 3 of Form N-1A.

299 *See supra* Sections III.C and III.D of this Release.

300 A recent opinion issued by the Second Circuit emphasizes the importance of accurate description and categorization of fund fees to investors. The court noted that the full and accurate description of both the amount and use of fees charged by a fund is an important part of the "total mix" of information in an investor's decision to purchase shares. *See Operating Local 649 v. Smith Barney Fund Management LLC*, 595 F.3d 86 (2d Cir. 2010) ("Few facts would likely constitute more important ingredients in investors' 'total mix' of information than the fact that, in violation of these disclosure requirements the expenses categorized as transfer agent fees were not transfer agent fees at all .... The importance of the accurate reporting of categories of fees in prospectuses is obvious: a "comparative" fee table is not useful to an investor if the information in the table is incomplete or otherwise misleading ....").

301 *See* Item 3 of Form N-1A.

expense ratios, but will affect the subcategories of the fee table. Because of the various uses and purposes of the charges that may be included as marketing and service fees under our proposal, we believe disclosure of this fee would fit best as a subheading to the "other expenses" category. We believe that it is important for investors to know whether a fund charges a marketing and service fee, but do not believe it requires its own heading in the fee table.

We request comment on the proposed location for the marketing and service fee disclosure in the fee table.

- Does including the marketing and service fee in the "other expenses" category raise any concerns that it may obscure the fact that all or a portion of the marketing and service fee is or may be used for distribution purposes? If so, would it matter to most investors?
- We request comment on the two headings and the names that we have proposed for them.[302] Would they help investors better understand the nature of the fees? Are there better names we could use? Should we require the disclosure of additional categories of fees? Should we require that additional fee information be provided in the fee table? For example, should the fee table indicate fees paid initially, annually, and upon redemption? Should we also require that the conversion period for the

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302 The Commission has long sought to find a descriptive term that both informs investors and accurately describes the fees deducted pursuant to a 12b-1 plan. In 1988, when we began requiring funds to disclose certain fee information in the form of a uniform fee table, fees deducted pursuant to a 12b-1 plan were simply listed as an annual operating expense called "12b-1 Fees." Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 16244 (Feb. 1, 1988) [53 FR 3192 (Feb. 4, 1988)]. This description of 12b-1 expenses was criticized as being uninformative, and in 1998 we made a number of amendments to Form N-1A, including renaming the "12b-1 Fee" heading as "Distribution [and/or Service] (12b-1) Fees." Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064, at text accompanying n.79 (Mar. 13 1998) [63 FR 13916 (Mar. 23, 1998)]. Similar to the approach we are proposing today, the hypothetical illustrative example that was a part of our summary prospectus proposal used separate headings (Distribution Fee and Service Fee) in the fee table. *See* Summary Prospectus Proposing Release, *supra* note 293.

ongoing sales charge be included in the fee table (or a footnote to the table), to provide investors with an immediate reference for how long the fee would be charged?

- We also request comment on our proposed use of the term "marketing and service fee." Is it too general a term to provide useful disclosure to investors? We are proposing this term instead of only the term "service fee" because funds could use the marketing and service fee for different activities than the "service fee" defined by the NASD, and because we are concerned that use of only the term "service fee" in some circumstances could mislead investors.[303] Should we permit funds that do not use the fees for distribution related purposes to use the term "service fee" in lieu of "marketing and service fee"? Would such an alternative diminish the comparability of fund fee tables and thus their usefulness to investors in comparing expenses among different funds? Would a different term, such as "sales and service fee" or "distribution and service fee" be more descriptive or informative to investors?[304]
- Finally, we request comment on fee table disclosure of asset-based distribution fees charged under existing 12b-1 plans, as permitted by proposed rule 12b-2(d).[305] Should Item 3 continue to require disclosure of "12b-1 fees" that are charged in the future?[306] Alternatively, should the 12b-1 fees be disclosed as marketing and service fees and ongoing sales charges, as appropriate? Should another term be used?

We also propose to amend Item 12(b) of Form N-1A, which currently requires funds that

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303 *See supra* note 100 and accompanying text.

304 *See supra* text following note 161.

305 *See infra* Section III.N.3 (treatment of "grandfathered" shares).

306 *See* Item 3 of Form N-1A (requiring disclosure of "Distribution [and/or Service] 12b-1 Fees").

have adopted 12b-1 plans to disclose information about the operation of the plan in the prospectus.[307] Because funds would no longer be required to have a "plan," we are proposing to eliminate this requirement. Instead, we would require funds to disclose whether they charge a marketing and service fee or an ongoing sales charge and, if they do, to disclose the rates of the fees and the purposes for which they are used.[308] In addition, if the fund deducts an asset-based distribution fee for services provided to fund investors, it would need to describe the nature and extent of the services provided.[309] We would also require a fund that imposes an ongoing sales charge to disclose the number of months (or years) when the shares will automatically convert (to another class without the charge) and after which the shareholder would cease paying the charge.[310]

We would also require a fund offering multiple classes of shares in a single prospectus (each with its own method of paying distribution expenses) to describe generally the circumstances under which an investment in one class may be more advantageous than another class.[311] We understand investors often face difficulties when deciding which share class they should purchase because the advantages and disadvantages of each class are not always clearly presented in the prospectus.[312] Although the differing fees and terms of each class currently are

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307 This disclosure complements the information presented in tabular form in the fee table.

308 Proposed Item 12(b) of Form N-1A.

309 *Id.*

310 For funds that choose the account-level sales charge alternative, existing regulatory provisions would generally require the delivery of similar information to investors in their confirmation statements. *See* rule 10b-10 under the Exchange Act [17 CFR 240.10b-10].

311 Proposed Item 12(b)(2) to Form N-1A.

312 FINRA has addressed, on numerous occasions, the responsibilities of its members in helping investors understand and evaluate the sales structures of different classes of funds. *See, e.g.*, Special Notice to Members 95-80 (Sept. 1995) (http://finra.complinet.com/finra/display/display_content.html?rbid=1189&element_id=1159003637).

readily available, the actual consequences of the decision to purchase a particular class (in terms of overall loads paid, appropriate holding periods, *etc.*) may not be readily apparent. We believe that requiring funds to provide a clear description of the situations in which one class may be more advantageous than another would reduce shareholder confusion and simplify the investment decision making process, and we understand that some funds currently provide this type of disclosure.

We request comment on these proposed amendments to Item 12(b).

- Would the disclosure be useful to investors in identifying the appropriate class to purchase? Should we provide more specific disclosure requirements? If so, what should they be? Would funds have difficulties in providing this information?

We are also proposing to amend Item 19(g) of Form N-1A, which currently requires a fund to describe in detail the material aspects of its 12b-1 plans and related agreements, in the Statement of Additional Information (SAI). Under our proposals, funds would no longer be required to have written "plans" that are approved by the board of directors, and thus much of this item would no longer serve any purpose. We therefore propose to eliminate paragraphs 2 through 6 of Item 19(g).[313] Because these items relate to the specific operation of a 12b-1 plan that would no longer be required under our proposal, we believe that they should be removed.

See also FINRA, *Understanding Mutual Fund Classes* (Jan. 14, 2003) (http://www.finra.org/Investors/protectyourself/InvestorAlerts/MutualFunds/p006022).

313 Item 19(g)(2) requires a fund to disclose the relationship between the amounts paid to the distributor under a 12b-1 plan and the expenses it incurs. Item 19(g)(3) requires disclosure of any unreimbursed expenses incurred by the plan and carried over to future years. Item 19(g)(4) requires disclosure of any joint distribution activities with another fund and the method of allocating distribution costs (any joint arrangement between funds that implicates section 17(d) and rule 17d-1 would require the funds to apply for and obtain an exemption from the Commission prior to implementing the arrangement). Item 19(g)(5) requires disclosure of whether any interested person or director has a financial interest in the operation of the 12b-1 plan. Item 19(g)(6) requires disclosure of the anticipated benefits of the plan to the fund.

- We request comment as to whether we should retain any of these parts of Item 19(g).

We believe that some of the other information required to be disclosed under Item 19(g) may continue to be useful to investors and the Commission. In particular, Item 19(g)(1) which includes a list of the principal activities paid for under the plan and the dollar amounts spent on each activity over the last year as a material aspect of a 12b-1 plan, may help investors to more clearly understand how the asset-based distribution fees they pay are used. We propose to amend Item 19(g) to eliminate references to the 12b-1 plan, and instead require disclosure of the principal activities paid for through asset-based distribution fees (both ongoing sales charges and marketing and service fees). As proposed, the amendment would not require disclosure of dollar amounts.[314]

We request comment on the proposed amendments to Item 19(g).

- Specifically, we request comment whether we should retain the disclosures required by Item 19(g)(1) as it currently exists, including the dollar amounts spent on each activity. Our proposal would remove this disclosure because we believe that the information is unlikely to be important to investors. Should these disclosure requirements be eliminated or retained? Should we require funds to disclose the percentage of fees spent on each type of activity instead? Are there any other activities that are not disclosed in Item 19(g) that should be disclosed under our proposal?

Finally, we propose to: (i) amend Item 25 of Form N-1A to add a paragraph (d) requiring funds electing to rely on the exemption to section 22(d) of the Act provided by rule 6c-10(c) to

[314] We do not believe that disclosure of the actual dollar amount spent on these activities would be useful to investors because that figure would depend primarily on the size of the fund, and not the services purchased.

state that the fund has made this election; and (ii) eliminate existing Item 28(m) of Form N-1A, which requires a registered fund to attach its rule 12b-1 plan and any related agreements as an exhibit to its registration statement. The exhibit would be unnecessary because proposed rule 12b-2 would not require a written plan, and funds that charge grandfathered fees would not be required to have a written plan.[315]

- We request comment on these proposed changes to Item 25 and Item 28(m) of Form N-1A.

2. *Amendments to Schedule 14A*

Our proposal would require funds to obtain shareholder approval before instituting or increasing the rate of marketing and service fees deducted from fund assets in existing share classes.[316] To obtain shareholder approval, funds generally have to solicit proxies from their shareholders, and those proxy solicitations must include sufficient information to allow shareholders to make an informed decision. Item 22(d) of Schedule 14A under the Exchange Act[317] requires funds to disclose information regarding any distribution plan adopted under rule 12b-1 and the fees paid under the plan when soliciting proxy votes for approval of any material

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[315] *See infra* Section III.N.3 for a discussion of grandfathering funds and share classes. We also are proposing additional conforming, technical changes to other items of Form N-1A, including: Instruction 3(b) to Item 3; Item 26(b)(4); and Item 27(d)(1) (and Instruction 2(a)(i) to Item 27(d)(1)). These changes are necessary to delete references to rule 12b-1 and rule 12b-1 plans and add references to rules 12b-2(b) and (d) and to 6c-10(b) as the operative rules regarding asset-based distribution fees.

[316] Generally, as allowed by rule 12b-1 (and as our proposal would allow), most funds institute a marketing and service fee or an ongoing sales charge before a fund is offered for sale to the public. *See* rule 12b-1(b)(1); Section III.F of this Release. If a fund wishes to institute a new marketing and service fee after a public offering, or increase those fees, the fund would be required to disclose in the proxy the information discussed in this section of the Release. As discussed in Section III.F, funds may not increase or impose an ongoing sales charge in a share class of a fund after any public offering of the fund's voting shares or the sale of such shares to persons who are not organizers of the fund.

[317] 17 CFR 240.14a-101.

change in that plan. This disclosure is designed to provide shareholders with relevant information regarding the distribution costs of the fund when they are voting on issues that impact their investment.[318] Our proposal would eliminate the need for a distribution plan as currently required by rule 12b-1, which would make much of the disclosure required in Item 22(d) of Schedule 14A no longer relevant. Therefore, we propose to amend Item 22(d) of Schedule 14A, as well as replace the term "distribution plan" used in Schedule 14A with the new defined term "Marketing and Service Fee."[319]

Although our proposal would not require a distribution plan, it would permit funds to continue to use fund assets for distribution related purposes. In addition, it would require fund shareholders to approve any institution of, or increase in the rate of, marketing and service fees charged by the fund.[320] In order for fund shareholders to make appropriate and informed decisions, we believe that shareholders would continue to find information regarding the rate of marketing and service fees, the purposes of the fees, the reasons for any proposed increase, and the identity of certain affiliated recipients relevant to their voting decisions. Thus, we propose to leave these disclosures, which are currently required under Item 22(d), substantially unchanged.[321]

Because our proposal would not require any special action by the board of directors in approving marketing and service fees, we do not believe that information regarding the board of directors' consideration of these fees would be relevant to the shareholder voting decision.

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318 *See* Amendments to Proxy Rules for Registered Investment Companies, Investment Company Act Release No. 19957 (Dec. 16, 1993) [58 FR 67720 (Dec. 22, 1993)] at section II.F.

319 Proposed Item 22(a)(iii) of Schedule 14A would define "Marketing and Service Fee" to mean "a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b)."

320 *See* proposed rule 12b-2(b)(2).

321 *See* Item 22(d)(1)-(3) of Schedule 14A; proposed Item 22(d)(1), (2) of Schedule 14A.

Therefore, we propose to eliminate the disclosure requirements in Item 22(d) regarding director involvement in approving asset-based distribution fees.[322]

We also propose to eliminate the current requirement that funds disclose in Item 22(d) the aggregate dollar amount of distribution fees paid by the fund in the previous year. When we initially discussed such disclosure in 1979, we envisioned that the disclosure of aggregate dollar amounts could be useful for shareholders who were being asked to renew a 12b-1 plan.[323] This information may have been useful for shareholders who were evaluating whether the expenditure of dollar amounts was helpful to address certain problems or circumstances that the 12b-1 plan addressed. In light of our current proposal to eliminate 12b-1 plans, however, and the fact that the aggregate dollar amount of marketing and service fees primarily reflects the rate of the fee and the size of the fund (information that is readily available elsewhere), we believe this information is unlikely to affect a shareholder's decision to approve an increase in a marketing and service fee. Thus, we propose to eliminate the requirement to disclose information regarding asset-based distribution fees in Item 22(d).[324]

We request comment on our proposed changes to Schedule 14A.

- Should we require disclosure of any other aspects of marketing and service fees in the

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[322] *See* Item 22(d)(4) of Schedule 14A.

[323] *See* 1979 Proposing Release, *supra* note 33, at text accompanying n.37 ("If shareholders were being asked to vote on the renewal of a plan, it would appear appropriate to include as well the amount spent by the fund in the previous fiscal year, as a total dollar amount and as a percentage of average net assets during that period, and the benefits to the fund from such expenditures.").

[324] *See* Item 22(d)(2)(iii) of Schedule 14A. This information will continue to be available to investors in the financial statements that are included in annual and semi-annual shareholder reports. See Item 27 of Form N-1A (requiring the inclusion of financial statements required by Regulation S-X); 17 CFR 210.6-07 (Regulation S-X requirement that the statement of operations separately state management and service fees); proposed amendment to 17 CFR 210.6-07 (proposed requirement that Regulation S-X require the separate statement of "all fees deducted from fund assets to finance distribution activities" pursuant to rules 12b-2(b), (d) or 6c-10(b) under the Investment Company Act). In addition, directors will continue to review the amounts charged to funds in the course of their oversight of fund expenses.

proxy statement? Is information about the aggregate amount of marketing and service fees collected relevant and meaningful to investors? Should we include any requirement for disclosure of director involvement in the setting of marketing and service fees?

3. Request for Comment on Account Statement Alternative

The GAO previously suggested that the Commission consider requiring funds to disclose in account statements the actual dollar amount of fees and expenses that each shareholder directly or indirectly has paid as an investor in the fund.[325] Many commenters argued, however, that such an approach would be unduly costly and may not be helpful to shareholders.[326] We believe that our proposed amendments would improve transparency of distribution related expenses without requiring funds and intermediaries to incur the costs that these commenters have asserted are associated with account statement disclosures.[327]

- Is our assumption correct? Or should we pursue the recommendations made by the GAO and require account statement disclosure of the actual dollar amount of asset-based distribution fees? Would such account statement disclosure be helpful or useful to investors? Have technological advances permitted account statement disclosure to be provided to investors without undue costs?

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325 *See* GAO, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION, *supra* note 130. *See also* Roundtable Transcript, *supra* note 109, at 221 (Richard Phillips, K&L Gates) ("[I]f you had [disclosure of 12b-1 fees] in dollars and cents terms, if you had it in the account statements…I think you would get a mutual fund investing public that is more sensitive to the issue of sales charge. And, over the long run, it would have a competitive effect of a more informed investing public.").

326 *See, e.g.*, Comment Letter of the ICI (July 19, 2007); Comment Letter of W. Hardy Callcott (June 18, 2007). However, another commenter argued that account statement disclosure could provide useful information to shareholders. *See* Comment Letter of Access Data Corp. (July 19, 2007).

327 We note that we have addressed this issue in part by requiring that prospectuses include an example of the costs an investor would pay on a hypothetical $10,000 investment in the fund. *See* Item 3 of N-1A.

K. Proposed Conforming Amendments to Rule 11a-3

Section 11(a) of the Act requires exchanges between funds to be based on the relative net asset values of the shares to be exchanged.[328] Rule 11a-3 provides a conditional exemption permitting funds and fund underwriters to charge a sales load on shares acquired in certain exchanges between funds within the same fund group. Among other things, the rule limits the total combined sales load that may be charged on shares that have been subject to an exchange (*i.e.*, all sales loads incurred on both the exchanged and acquired shares) to the highest sales load rate applicable to those shares (exchanged or acquired) in the absence of an exchange.[329] This provision is designed to give shareholders credit for all sales loads paid in connection with a purchase of fund shares, regardless of whether the sales load was paid with respect to the exchanged or acquired shares.[330]

As discussed above, our proposed amendments to rule 6c-10 would treat traditional sales loads and the sales charge component of existing 12b-1 fees, (*i.e.*, the ongoing sales charge) similarly under the Act.[331] Accordingly, we propose two changes to rule 11a-3 that would conform that rule with our general approach.

1. *Credit for Ongoing Sales Charges Paid*

Paragraph (b)(4) of rule 11a-3 requires that funds, in determining any sales load due upon an exchange, give shareholders credit (*i.e.*, reduce the amount of sales load charged on the

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[328] Section 11(a) of the Act makes it unlawful for a fund or its principal underwriter to make an exchange offer to the fund's shareholders or to shareholders of another fund on any basis other than the relative net asset values of the shares to be exchanged, unless the terms of the offer are approved by the Commission or comply with Commission rules governing exchanges.

[329] Rule 11a-3(b)(4).

[330] Offers of Exchange Involving Open-End Investment Companies and Unit Investment Trusts, Investment Company Act Release No. 15494, at text following n.28 (Dec. 23, 1986) [51 FR 47260 (Dec. 31, 1986)].

[331] *See supra* note 141 and accompanying text.

purchase of new shares) for their previous payment of sales loads on the shares exchanged, but does not require funds to give shareholders credit for the payment of any rule 12b-1 fees. In order to ensure that shareholders are credited for all sales charges previously paid in connection with a purchase of fund shares, we propose to amend rule 11a-3(b)(4) to require funds to also give shareholders credit for the payment of ongoing sales charges.

We request comment on our proposed treatment of ongoing sales charges in rule 11a-3.

- Are there reasons not to treat a sales load and an ongoing sales charge in the same way when determining the amount of sales load due upon an exchange? Should we require funds to also give credit for any marketing and service fee paid under rule 12b-2 when calculating the sales load due upon an exchange? Should we require funds to also give credit for any 12b-1 fees previously paid on the exchanged shares? If so, should we limit the credit to fees paid in excess of 25 basis points (*i.e.*, the asset-based sales charge component of 12b-1 fees)? Would our proposed amendments to rule 11a-3 result in significant operational difficulties? Is there a simpler or less costly method of accomplishing the goal of ensuring that investors receive credit for ongoing sales charges during rule 11a-3 exchanges than the approach we are proposing?

2. *Deferred Sales Loads upon Exchange*

Rule 11a-3 prohibits funds from imposing a deferred sales load at the time of an exchange.[332] The provision was designed to remove the incentive for fund underwriters to induce shareholders to make exchanges in order to accelerate its collection of a deferred sales

[332] Rule 11a-3(b)(3).

load.[333] Under the rule, a fund may not treat an exchange as a redemption for purposes of assessing a deferred sales load, and thus may impose a deferred sales load only when the acquired shares are ultimately redeemed.[334] When the deferred load is imposed, the fund must determine the amount of the deferred load by "tacking" (*i.e.*, adding) the time the shareholder held shares of the exchanged fund to the time the shareholder held shares of the acquired fund.[335] However, in determining the amount of the deferred load, a fund may toll (*i.e.*, exclude) the time the acquired shares are held if a new sales load is not charged upon the exchange *and* credit is given to the investor for any 12b-1 fees paid with respect to the acquired shares.[336]

We propose to modify the "tolling" provision of rule 11a-3 to permit funds, in determining the amount of deferred sales load due upon ultimate redemption, to provide credit only for the sales charge component of any asset-based distribution fee, *i.e.*, the ongoing sales charge. Because the marketing and service fee is not considered to be an alternative sales charge under our proposal, we would not require funds to give credit for such fees when determining the sales load payable upon an exchange. In addition, we propose to modify the rule to clarify that funds must provide credit for ongoing sales charges in terms of the cumulative *rate* of the ongoing sales charge previously paid rather than the *amount* of fees paid. As discussed

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333 *See* Rule 11a-3 Adopting Release, *supra* note 186, at text following n.28.

334 Rule 11a-3(b)(5).

335 *Id.*

336 Rule 11a-3(b)(5)(i). The rule provides an analogous provision for acquired shares that have a CDSL. Rule 11a-3(b)(5)(ii). The rule recognizes that CDSLs typically are reduced over time to reflect amounts paid by investors indirectly through a 12b-1 plan. We reasoned that "if a shareholder is making any payments for distributions through a 12b-1 plan, those payments should be reflected in a commensurate reduction of the CDSL owed, [but] ... tolling would prevent a shareholder from receiving credit for the 12b-1 payments made while holding the acquired shares ...." *See* Offers of Exchange Involving Registered Open-End Investment Companies and Unit Investment Trusts, Investment Company Act Release No. 16504, at text following n.35 (July 29, 1988) [53 FR 30299 (Aug. 11, 1988)] (revised proposal of rule 11a-3). Thus, rule 11a-3 permits tolling of the time the acquired shares are held only if "a credit is given to investors for any 12b-1 fees with respect to the acquired shares ...." Rule 11a-3 Adopting Release, *supra* note 186, at text accompanying n.35.

previously, we understand that funds generally do not have the ability to track dollar amounts of 12b-1 fees that are attributable to individual shareholder accounts.[337] In addition, requiring that credit be given in terms of rates rather than dollar amounts would make rule 11a-3 consistent with the method of calculating maximum sales loads under rule 6c-10(b).[338]

- Should rule 11a-3 require funds to give shareholders credit for the payment of any marketing and service fee when relying on the tolling provisions? We request comment on any aspect of our proposed changes to rule 11a-3. Should rule 11a-3 operate in terms of dollar amounts instead of rates? Would it be difficult or costly for funds to comply with the new requirements? Is it difficult or costly for funds today to comply with the tolling provisions of rule 11a-3? Is our understanding correct that funds generally do not have the ability to track dollar amounts of 12b-1 fees? Would it be difficult or costly for funds to track these amounts?

L. Other Proposed Conforming Amendments

1. Rule 17a-8

Rule 17a-8 provides an exemption from section 17(a) of the Act to permit mergers of funds with certain of their affiliated persons, including other funds (affiliated funds), subject to certain conditions.[339] Among other requirements, the rule requires the board of the merging fund to have made certain determinations, the surviving fund to keep certain records, and the shareholders of the merging fund to approve of the merger.[340] The rule allows for affiliated funds to merge in the absence of a shareholder vote, if, among other conditions, the 12b-1 fees of

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337 *See supra* note 170 and accompanying text.

338 *See supra* Section III.D.1 of this Release.

339 "Affiliated person" is defined in section 2(a)(3) of the Act.

340 *See* rule 17a-8(a)(2), (a)(5), and (a)(3), respectively.

the surviving company are no greater than the 12b-1 fees of the merging company.[341] This condition prevents 12b-1 fees from being instituted or increased as a result of a merger on which the acquired fund's shareholders have not had an opportunity to vote.[342] We propose to preserve this protection by amending rule 17a-8 to replace references to rule 12b-1 with references to rule 12b-2(b) or (d) and rule 6c-10(b).[343]

- We request comment on this proposed revision. Should we continue to permit affiliated funds to merge in reliance on this provision in light of our new approach to asset-based distribution fees and the different role that fund directors would have in overseeing these fees under our proposal? Is there another approach we should take in amending rule 17a-8 to conform with our proposal?

2. *Rule 17d-3*

When the Commission adopted rule 12b-1 in 1980, it also adopted rule 17d-3 because a fund's payments for distribution under a rule 12b-1 plan may involve it in a "joint enterprise" with an affiliated person that otherwise would be prohibited by section 17(d) of the Act and rule 17d-1 unless an application regarding the joint arrangement was filed with the Commission and granted by order.[344] The rule grants an exemption for funds to enter into agreements with certain affiliated persons and the fund's principal underwriter in connection with the distribution of its

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341 Rule 17a-8(a)(3)(iv).

342 Investment Company Mergers, Investment Company Act Release No. 25666 (July 18, 2002) [67 FR 48512 (July 24, 2002)].

343 *See* proposed amendments to rule 17a-8(a)(3)(iv).

344 *See* 1980 Adopting Release, *supra* note 23, at section titled "Proposed Rule 17d-3" (rule 17d-3 was adopted in the same release as rule 12b-1). Section 17(d) of the Act and rule 17d-1, in general, prohibit an investment company from entering into a "joint enterprise or other joint arrangement or profit-sharing plan" (as defined in the rule) with any affiliated person or principal underwriter (or their affiliated persons) unless the Commission by order grants an exemption before the agreement goes into effect.

shares, provided that such an agreement is in compliance with rule 12b-1, among other requirements.[345]

We believe that under our proposed new rules, funds should continue to be afforded the exemption provided by rule 17d-3 with respect to distribution payments made to certain affiliated persons and the principal underwriter, so long as those payments are consistent with the conditions set forth in proposed rule 12b-2 and amended rule 6c-10.[346] We therefore propose to revise rule 17d-3(a) to replace the reference to 12b-1 with references to rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b) in order to permit a fund to enter into an asset-based distribution fee arrangement with an affiliated underwriter.[347]

- We request comment on any aspect of this proposed revision. Would the revised role of directors in approving asset-based distribution fees under our proposal make this type of exemption less warranted? Is there another approach we should take in revising rule 17d-3 to conform with our proposal?

3. *Rule 18f-3*

Rule 18f-3 permits funds to offer multiple classes of fund shares. Section (f) of the rule permits funds to convert shares of one class to shares of another class after a specified period of time, provided that, among other things, the expenses (including 12b-1 fees) charged to the converted class are no higher than the expenses of the original share class. We believe that,

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345 The Commission stated that prior review and approval as required by rule 17d-1 would not be necessary if the safeguards of rule 12b-1 have already been applied to the arrangement. 1979 Proposing Release, *supra* note 33. The exemption does not extend to arrangements for the joint sharing of distribution costs by funds that are affiliates (or affiliates of affiliates) of each other (*e.g.*, mutual funds in the same fund complex). 1980 Adopting Release, *supra* note 23, at section titled "Proposed Rule 17d-3."

346 We note that fund boards would continue to review and scrutinize arrangements involving asset-based distribution fees and ongoing sales charges, as discussed above. *See supra* section III.D.4.

347 *See* proposed amendments to rule 17d-3(a).

under our proposed amendments, funds should continue to be able to convert shares under the same conditions. We believe that expenses attributable to proposed rule 12b-2 and proposed amendments to rule 6c-10 should be taken into account when making these conversions, much like rule 12b-1 expenses are today. We therefore propose that rule 18f-3(f)(ii) be amended to delete the reference to 12b-1 fees and replace it with references to fees under rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b).[348]

- We request comment on any aspect of this revision. Is there another approach we should take in revising rule 18f-3 to conform with our proposal?

4. *Forms N-3, N-4, and N-6*

Form N-3 is the registration form used by insurance company separate accounts registered as management investment companies that offer variable annuity contracts. Instruction 2 to Item 7(a) requires separate accounts to disclose, among other things, the principal activities for which 12b-1 payments are made and the total amount spent under a 12b-1 plan in the most recent fiscal year, as a percentage of net assets. We believe that most of the information required to be disclosed by Instruction 2 to Item 7(a) would continue to be useful to investors and the Commission, and thus we propose to amend Instruction 2 to Item 7(a) to replace references to rule 12b-1 and 12b-1 plans with references to asset-based distribution expenses incurred under rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b). The proposal would eliminate the requirement that registrants disclose the total amount spent in the most recent fiscal year (although this information would continue to be available in funds' financial statements), and would instead require registrants to provide a description of asset-based distribution fees. As discussed above, disclosure of the aggregate total of asset-based distribution fees may not be

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[348] *See* proposed amendments to rule 18f-3(f)(ii).

helpful to investors because it primarily reflects the size of the fund and not the distribution activities that are paid for with these amounts.[349] The proposal would retain the requirement that registrants list the principal types of activities for which asset-based distribution fees are charged.

As discussed above, under our proposals funds would not be required to have written "plans" that are supervised and approved by the board of directors. We therefore propose to eliminate paragraphs (ii) and (iii) of Item 21(f) because these items relate to the specific operation of a 12b-1 plan that would no longer exist under our proposal.[350]

- We request comment whether we should retain any of these parts of Item 21(f).

We believe, however, that the information required to be disclosed in paragraph (i) of Item 21(f), which requires registrants to disclose the manner in which amounts paid by the registrant under a 12b-1 plan were spent, would continue to be useful to investors and the Commission. This information may be relevant to an investor making an investment decision because it discloses the types of services the fund (and its investors) may receive in exchange for these fees. We propose to amend Item 21(f) to eliminate references to the 12b-1 plan, and instead require disclosure of the principal activities paid for through asset-based distribution expenses incurred under rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b). For the reasons discussed above, we also propose to amend Instruction 5 to Item 26(b)(ii)[351] to delete any references to 12b-1 plans.[352] However, registrants would be required to provide the same information with respect to expenses and reimbursements accrued pursuant to rule 12b-2(b), rule

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[349] *See supra* note 323 and accompanying text.

[350] Item 21(f)(ii) requires a registrant to disclose whether any interested person or director has a financial interest in the operation of the 12b-1 plan. Item 21(f)(iii) requires disclosure of the anticipated benefits of the plan to the fund.

[351] Instruction 5 to Item 26(b)(ii) explains how registrants should include expenses related to 12b-1 fees in the calculation of their performance data.

[352] *See* proposed amendments to Instruction 5 to Item 26(b)(ii).

12b-2(d) and rule 6c-10(b).

- We request comment on any aspect of these proposed revisions to Form N-3.

We are also proposing to amend the fee tables in Forms N-4 and N-6, the registration forms used by insurance company separate accounts registered as unit investment trusts that offer variable annuity contracts and variable life insurance contracts, respectively. We propose to replace existing references to "distribution [and/or service] (12b-1) fees" with a new defined term, "asset-based distribution fees." We also propose to add new instructions that would define the term "asset-based distribution fee" as "all asset-based distribution fees paid under rule 12b-2(b), rule 12b-2(d), and rule 6c-10(b)."

- We request comment on these proposed revisions to Forms N-4 and N-6.

5. *Form N-SAR*

We are proposing to amend the instructions to Form N-SAR, the reporting form that is used by mutual funds for filing annual and semi-annual reports with the Commission.[353] Form N-SAR currently requires funds to answer a series of five questions about their 12b-1 plans in a yes/no or fill-in-the-blank format, which provides the Commission information regarding the use and amount of 12b-1 fees. The first of these questions asks a fund to state whether it has adopted a rule 12b-1 plan, and if the answer is "no," the fund need not answer the next four questions.[354] Because under our new approach funds would no longer be required to have 12b-1 plans, funds would answer "no" to the first question, and would not be required to respond to the remaining four questions. Under the proposed amended instructions, funds with share classes subject to a grandfathered 12b-1 plan (as discussed in Section N.3 below) would respond "yes" to the first

[353] Mutual funds that have effective registrations statements for their shares under the Securities Act are required to file annual and semi-annual reports with the Commission on Form N-SAR under section 30(b) of the Act and rule 30b1-1.

[354] Item 40 of Form N-SAR.

question, and provide the information required in the remaining questions. Funds that do not have grandfathered 12b-1 plans would answer "no" to the first question, and would not be required to respond to the remaining four questions.

Although the operation of grandfathered 12b-1 fees would differ in certain ways from current 12b-1 fees if the proposal is adopted (primarily because there would no longer be board approval of a 12b-1 plan), those differences should not affect the disclosures required under Form N-SAR, and this information could continue to be useful to the Commission and investors.

- We request comment on our proposed changes to Form N-SAR. Should we delete the Form N-SAR questions related to 12b-1 plans entirely and not require funds with grandfathered share classes to answer the questions? Or should we amend the questions so that they apply not only to funds with a 12b-1 plan, but also to any fund with asset-based distribution fees pursuant to our proposed new rule 12b-2 and amended rule 6c-10? Is there a continuing need for the information to be disclosed in the questions related to 12b-1 plans in Form N-SAR if our proposal is adopted?

6. Regulation S-X

Mutual funds must include in their registration statements and shareholder reports the financial statements required by Regulation S-X.[355] As part of this requirement, mutual funds file a statement of operations listing their income and expenses.[356] Under the expense category, funds currently must state separately all amounts paid in accordance with a plan adopted under

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[355] Item 27 of Form N-1A. Article 6 of Regulation S-X contains special rules applicable to the financial statements of registered investment companies. 17 CFR 210.6-01 *et seq.*

[356] Rule 6-07 of Regulation S-X contains the requirements for an investment company's statement of operations. 17 CFR 210.6-07. The statement of operations reports changes in a fund's net assets resulting from the amount of net investment income, net realized gains and losses on investments, and net unrealized appreciation or depreciation of investments.

rule 12b-1.[357] We propose to delete the reference to rule 12b-1 and replace it with a requirement that funds list separately, in two line items in the statement of operations, the portion of this expense that represents marketing and service fees under proposed rule 12b-2(b), and the portion of this expense that represents ongoing sales charges under proposed amendments to rule 6c-10(b) or other fees under rule 12b-2(d).[358] Multiple-class funds would be permitted to disclose the marketing and service fees and ongoing sales charges incurred by each class either in the statement of operations or in a note to the financial statements, so that investors in each class would have an understanding of the expenses paid by their particular distribution arrangement. This change is designed to provide investors with information about marketing and service fees and ongoing sales charges in a fund's financial statements and is consistent with the proposed changes to the prospectus fee table.[359] In addition, funds that receive reimbursements relating to distribution would continue to report these reimbursements as a negative amount and deduct them from current 6c-10(b), 12b-2(b) or (d) expenses in the statement of operations.

- We request comment on the proposed amendments. Would listing ongoing sales charges in the statement of operations help investors understand that they are paying a sales charge as part of their investment in the fund? Should this information be presented in the statement of operations separately for each class of the fund? Is a note to the financial statement the appropriate place to provide this information? If not, where should we require disclosure of class-specific information? Should we also require that the conversion period for the ongoing sales charge be included in

[357] 17 CFR 210.6-07.2(f).

[358] Shares subject to grandfathering under proposed rule 12b-2(d) would continue to list asset-based fees as a single line item, as under current practices.

[359] *See supra* Section III.J of this Release.

shareholder reports to provide investors with a regular reminder and reference for how long the fee would be charged?

M. Potential Impact of Proposed Rule Changes

Our rule proposals are designed to resolve many of the difficulties that investors, as well as fund directors, managers, underwriters, and intermediaries, have experienced with rule 12b-1 and 12b-1 fees over the years. We also recognize that, if adopted, our proposals would affect how some fund groups and their distributors conduct business. The benefits and potential impacts of the proposed rule changes on various market participants, which we summarize below, are also discussed further in the Cost-Benefit Analysis contained in Section V of this Release.

1. Fund Investors

Our proposals are designed to make it easier for fund investors to understand fund expenses. As a result, investors would be better able to select the fund or fund class that offers the combination of costs and services that is most advantageous for them. In addition, our proposals would provide for equivalent limitations on sales charges for shareholders who invest in a fund through a class of shares that charges front-end sales loads and those who choose to invest in a class of shares that bears an ongoing sales charge. We believe the proposals would yield investors two benefits. First, they would protect investors from the imposition of excessive sales loads, in furtherance of the goals of section 22(b) of the Act,[360] by limiting the cumulative amount of sales charges that an investor could bear directly or indirectly.[361] Second, they would promote a fairer allocation of distribution costs among investors who invest through different share classes by limiting the extent to which one class of shares (*e.g.*, class C shares) may bear

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[360] *See supra* note 20.

[361] *See infra* Section III.N.3 (discussing grandfathered share classes).

these costs. In addition, the proposed rule amendments may lead to lower distribution costs if greater retail price competition develops.

Some investors wrote to us urging the elimination of rule 12b-1 as a way of reducing the cost of owning mutual funds.[362] Although one consequence of the proposed rule amendments may be to reduce distribution costs, the elimination of asset-based sales charges would not eliminate the need to compensate fund intermediaries for fund distribution and for the other services they provide. Investors who do not want to pay 12b-1 fees have available to them a range of funds that do not charge these fees, although investors in these funds may pay distribution costs through other means. In recent years, expenses of funds as a group have begun to decline as more investors have sought funds with lower expenses, and as index funds and exchange-traded funds have become more popular with investors.[363] We believe that more transparent disclosure of fund expenses may help investors to better evaluate different fund options. This transparency also may lead to greater competition among funds and ultimately downward pressure on fund costs.

2. *Fund Intermediaries and Distributors*

We received comments from a large number of financial planners, broker-dealer representatives, and brokerage firm managers who expressed concern that the "trail commissions" or "service fees" they receive from the proceeds of 12b-1 fees might be cut off as a result of this rulemaking, and they could no longer provide ongoing services to their

[362] *See, e.g.*, Comment Letter of Melvyn H. Mark (June 17, 2007); Comment Letter of Jack Thomas (June 19, 2007); Comment Letter of Weiwan Ng (June 19, 2007).

[363] *See, e.g.*, Fee Trends Report, *supra* note 22 (discussing the decline in expense ratios during the past 20 years, but noting that the expense ratios of stock funds and bond funds increased in 2009).

customers.[364] These proposals should address these concerns.[365] Approximately 80 percent of fund assets that are subject to 12b-1 fees are charged 12b-1 fees of 25 basis points or less. They therefore would not be subject to the portion of our rule proposals related to ongoing sales charges.[366]

Intermediaries that may be affected by our proposed rules are primarily broker-dealers that currently receive payments from the sale of classes of fund shares that pay 12b-1 fees that exceed 25 basis points (*e.g.*, class C shares). Under our rule proposals, funds could continue to pay broker-dealers 12b-1 fees at previously approved levels for grandfathered shares.[367] For shares issued after the compliance date, fund underwriters would likely reduce the stream of payments when the shares convert to a class that pays no more than 25 basis points of asset-based distribution expenses (*e.g.*, class A shares) or else find a different source of revenue to fund the payments. The amount of time before conversion would depend on the amount of sales load charged on the class A shares, *i.e.*, the reference load, and the rate of the ongoing sales charge (the amount of asset-based distribution fees that exceeds 25 basis points). Thus, for example, if a fund offers class A shares with a 5.25 percent front-end load and class C shares with an ongoing sales charge of 75 basis points, then the class C shares would have to convert no later than seven years from the time of purchase.[368] This consequence flows from the premise

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364 *See, e.g.*, Comment Letter of Jill Shannon (Aug. 6, 2007); Comment Letter of Bernard Smit (Oct. 9, 2007); Comment Letter of Eric Connors (June 19, 2007)). *See also* Comment Letter Type A and Comment Letter Type B.

365 *But see supra* notes 100 and 168 of this Release.

366 According to industry statistics derived from Lipper's LANA Database analyzed by our staff, funds that charge 12b-1 fees have aggregate assets of $4.86 trillion, which we assume is the source of payments for trail commissions or services fees (or a combination) to intermediaries. 12b-1 fees of 25 basis points or less are charged on approximately 82 percent of these assets ($4.0 trillion).

367 *See infra* Section III.N of this Release.

368 We calculated the length of the conversion period by dividing the rate of the front-end load (5.25%) by the rate of the ongoing sales charge (0.75%).

(discussed above) that amounts paid by funds in excess of the marketing and service fee are charged as an alternative to sales loads, and thus are properly limited by the NASD sales load caps.

Some commenters and roundtable participants described "level load" classes of shares as providing for an alternative to front-end or spread-load arrangements, and thus acknowledged them as a form of sales load designed to support distribution of fund shares.[369] Others, however, have asserted that the 12b-1 fees associated with level load funds (often 100 basis points) pay for valuable ongoing investment advice provided by the intermediary, and are an alternative to mutual fund wrap fee programs, which often charge a 100 basis point (or greater) wrap fee.[370] The use of fund assets to finance personal advisory services (rather than support fund distribution), however, raises issues regarding whether those advisory services provided by an intermediary to a customer years after the sale ought to be payable from fund assets. Such expenditures arguably do not relate to the operation of the fund or to the distribution of its shares.

- We request comment on these matters. Are asset-based distribution fees associated with level load share classes an efficient means to pay for ongoing investment advice?

With respect to level load share class arrangements, roundtable panelists and commenters raised questions regarding the applicability of the Investment Advisers Act of 1940 ("Advisers

[369] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 198-99 (Richard Phillips, K&L Gates) ("I think you have got to separate the 25 basis point service fee from the 75 basis point sales compensation fee, or broker's compensation fee .... The 75 basis point substitute for the front-end load ... is pure sales compensation.").

[370] *See, e.g.*, Comment Letter of Gregory A. Keil (June 1, 2007) ("The current 'Class C' share is really the next step toward a more 'advice driven' model ... removing a 'transaction cost' from the equation – and applying an "always-on" Advisory Fee to a DISCRETIONARY investment vehicle – the mutual fund ...."); Comment Letter of Daryl Nitkowski (July 19, 2007) ("In fact, I believe the typical 1% fee charged on class C shares represents the best option for clients who want continuing advice, but do not want to have a fee based account.").

Act")[371] to intermediaries that receive those ongoing fees.[372]

- We request comment on these matters, and whether the conversion provisions of our proposed rules would appropriately address them by requiring a nexus between the sale of a share of a mutual fund and the amount of ongoing sales charges an intermediary's customer pays through the fund.

Finally, we note that our proposed relaxation of restrictions on retail price competition could provide fund intermediaries with greater control over the pricing of fund shares sold to their customers by permitting intermediaries to establish their own sales loads specifically tailored for their customers. This may result in greater competition among intermediaries and in particular may impact smaller broker-dealers that lack the distribution capacity and negotiating ability of larger broker-dealers. However, some smaller broker-dealers may use this alternative to create new pricing structures that permit them to better compete with larger broker-dealers.

- We request comment on the likely effects on competition that may result from our proposal, including the effects with regard to smaller broker-dealers.

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371 15 U.S.C. 80b.

372 Intermediaries that are broker-dealers are excluded from the definition of investment adviser under the Advisers Act with respect to advice they provide that is "solely incidental to the conduct of [their] business as a broker or dealer" and for which they receive "no special compensation." Section 202(a)(11)(C) of the Advisers Act [15 USC 80b-2(a)(11)(C)]. Some commenters asserted that broker-dealers receiving 12b-1 fees are ineligible for this exclusion. *See, e.g.*, Comment Letter of Ron A. Rhoades (June 18, 2007) ("It is clear from various comments recently submitted by broker-dealer firm registered representatives, as well as … industry representatives and the ICI, that 12b-1 fees are being utilized as 'special compensation' for advice which is ongoing … and which clearly cannot be considered incidental to the mutual fund sales transaction …. I would submit that the payment of 12b-1 fees for such purposes violates the Investment Advisers Act, when such fees are paid in connection with brokerage (not investment advisory) accounts."); Comment Letter of Harold Evensky (June 26, 2007). *See also* Roundtable Transcript, *supra* note 109, at 203 (Barbara Roper) ("The other thing I would just like to point out, having listened to today's discussion, this advice we're getting doesn't sound remotely like anything I would call solely incidental to product sales. And these fees sound a lot like special compensation for advice."). *See also* Beagan Wilcox Volz, *Class Action Firm Mounts Legal Attack on 12b-1 Fees*, IGNITES (Apr. 9, 2010) (discussing recent lawsuits alleging that broker-dealers may not properly receive 12b-1 fees without registration as investment advisers).

3. Fund Managers and Principal Underwriters

Our proposals would largely preserve existing distribution arrangements, and should provide fund managers, directors, etc., with greater legal certainty regarding many distribution financing practices that have developed over the years.[373] In this regard, our proposals would respond to the many calls we have received from mutual fund managers and others to revise rule 12b-1 in a way that recognizes that 12b-1 fees are today a substitute for sales loads, and to eliminate the procedural requirements of the rule that they view as outdated.[374]

Today's proposals are designed to address the criticism of funds and fund managers expressed by investors, the academic community, and the financial press who argue that rule 12b-1 fees may not collectively benefit fund shareholders because they do not produce economies of scale and, in fact, operate to increase fund expense ratios.[375] We anticipate that the proposed rules, if adopted, would shift the focus from whether fund expenses are increased by a 12b-1 fee to whether the sales charges imposed by a particular fund are appropriate in light of the services provided by the intermediary. This is the issue we believe investors should be exploring before they decide to invest in a fund and pay sales charges.

4. Small Fund Groups

Some fund and broker-dealer industry participants expressed concern about the possible

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[373] One of the uncertainties involves whether fund boards can appropriately approve continuation of 12b-1 fees for funds that are no longer selling shares. *See* Standard & Poor's, *Closed Funds and 12b-1 Fees* (Aug. 2008) (http://www2.standardandpoors.com/spf/pdf/index/concept_12B1-Fess&ClosedFunds.pdf) (the existence of 12b-1 fees in funds closed to new investments may seem "counter-intuitive," but may be appropriate when viewed as a substitute for a sales load).

[374] *See supra* Section II.E.

[375] *See, e.g.*, Haslem, *supra* note 108; William Dukes et al., *Mutual Fund Mortality, 12b-1 Fees, and the Net Expense Ratio*, 29 J. FIN. RES. 235 (2006); Charles Trzcinka & Robert Zweig, *An Economic Analysis of the Cost and Benefits of SEC Rule 12b-1*, MONOGRAPH SERIES IN FINANCE AND ECONOMICS 67 (Leonard N. Stern School of Business, NYU) (1990). *See also* William P. Dukes & James B. Wilcox, *The Difference Between Application and Interpretation of the Law as It Applies to SEC Rule 12b-1 Under the Investment Company Act of 1940*, 27 NEW ENG. L. REV. 9 (1992).

effects of changes to rule 12b-1 on smaller fund groups. Several asserted that use of fund assets to pay for distribution has played an important role in permitting smaller fund groups to compete with larger fund groups for the attention of intermediaries by permitting them to access a wide array of distribution networks.[376] Of particular importance to small funds is their continued ability to use fund assets to pay for participation in fund supermarkets,[377] which are an important means by which investors find smaller fund groups.[378] A number of studies of the role of brokers and fund supermarkets in selling shares of mutual funds offered by smaller fund groups appear to support these assertions.[379]

In developing our proposals, we have considered their potential effect on smaller fund groups. A representative of a smaller fund group participated in our roundtable discussion, and our staff met with representatives from other small fund groups to listen to their concerns and explore ways in which we might address them.

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[376] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 67-68 (Mellody Hobson, Ariel Capital Management). *See also* Comment Letter of Thornburg Investment Management (July 19, 2007) ("[L]arge brokerage firms have increasingly become more open to using funds managed by independent advisors, rather than relying entirely on in-house managed products" because of compensation from 12b-1 fees); Comment Letter of the Securities Industry and Financial Markets Association (July 19, 2007) ("[A]vailability of 12b-1 fees makes smaller funds more attractive to larger intermediaries, and correspondingly smaller intermediaries, that do not enjoy the same economies of scale as larger ones, are able to support and offer a broader choice of funds for their clients"); Comment Letter of the ICI (July 19, 2007) ("[T]he ability of small funds to assess asset-based distribution fees has enabled these funds to remain competitive by allowing them to gain access to a wider array of distribution channels . . . .").

[377] *See supra* note 96.

[378] *See* Comment Letter of Charles Schwab & Co., Inc. (July 16, 2007) ("Repeal of rule 12b-1 would undoubtedly restrict a fund's ability to rely on supermarkets and their superior infrastructure, and, in particular, we believe it would have a disproportionate impact on smaller and new funds that lack the resources outside of fund assets to pay for shareholder servicing.").

[379] Conrad S. Ciccotello et al., *Supermarket Distribution and Brand Recognition of Open-End Mutual Funds*, 16 FIN. SERVS. REV. 309 (Winter 2007) (http://findarticles.com/p/articles/mi_qa3743/is_200701/ai_n25499878) (fund families that are focused and smaller in size are more likely to rely on fund supermarkets for distribution); Xinge Zhao, *The Role of Brokers and Financial Advisors Behind Investments Into Load Funds* (August 2003) (http://ssrn.com/abstract=438700) (brokers and financial advisors are more likely than self-directed investors to allocate investment dollars to smaller funds).

We believe that our proposal reflects consideration of the concerns small fund groups shared with us, and would preserve their ability to compete with larger fund groups. Based on an analysis of data collected from the Lipper LANA Database by our staff, we estimated that approximately 108 "small fund groups," offered 189 classes of fund shares to the public.[380] Our analysis found that of these classes, 166 (88 percent) either charged no 12b-1 fee or charged a 12b-1 fee of 25 basis points or less.[381] The remaining 23 classes (12 percent), under our proposal, would be required to comply with the limits on ongoing sales charges, reduce their distribution expenditures, or otherwise change their distribution arrangements. Alternatively, as discussed above, where non-distribution related expenses are now paid under 12b-1 plans, many funds may be able to allocate that portion of their existing 12b-1 fees to administrative expenses, and thus ensure that their asset-based distribution expenses fall within the limits of the 25 basis points marketing and service fee.[382]

Only 11 of the small fund groups (6 percent) offered class C shares, and fund assets attributable to these classes amounted to only $60 million of assets (0.2 percent of small fund group assets). Based on this data, we do not believe that our proposals would require many small funds to restructure their fund classes.[383]

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[380] We are using, for purposes of our estimates, the definition of "small business" or "small entity" that we use for purposes of the Regulatory Flexibility Act [5 U.S.C. 601, *et seq.*]. Rule 0-10 under the Act defines a "small entity" for purposes of the Act as a group of related management companies (funds) that has net assets of $50 million or less as of the end of its most recent fiscal year.

[381] 111 classes (59 percent) do not have a 12b-1 plan in effect.

[382] *See supra* Section III.C of this Release. *See also* Roundtable Transcript, *supra* note 109, at 89 (Mellody Hobson, Ariel Capital Management) (explaining that Ariel funds may treat 15 basis points of a 40 basis point fund supermarket fee as a sub-transfer agent fee.).

[383] Our staff also evaluated the potential impact of our proposal on somewhat larger fund groups – those with less than $250 million of assets under management – and obtained similar results. This group consisted of 191 fund groups that offered 497 share classes. Of these classes, 397 (79.9 percent) carried no 12b-1 fee or a fee of 25 basis points or less. Only 22 of the 191 fund groups offered class

- We request comment on the impact of our proposals on small fund groups. In particular, we request comment on the competitive impact of our rule proposals on smaller fund groups. Is this data correct? Should our rules treat small fund groups differently than larger fund groups?

5. *Retirement Plans*

Many investors invest in mutual funds through tax-advantaged retirement plans, such as 401(k) plans.[384] Some of these funds use fund assets to compensate plan administrators for services provided to plans and plan participants, including recordkeeping, sub-accounting, transaction processing, account maintenance services, and participant education.[385] Many of these payments essentially reimburse plan administrators for costs they incurred to provide services (such as shareholder recordkeeping) that typically funds would have to bear as operational expenses for direct accounts.[386] Other payments, in whole or in part, may be distribution related, and thus many funds today make them to plan administrators and financial intermediaries pursuant to a rule 12b-1 plan.[387] Different funds take different approaches to

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C shares (11.5 percent), with total assets of approximately $400 million (3.5 percent of the assets of these fund groups). *See also* Section V.B of this Release.

384 According to data compiled by the ICI, 36 percent of long-term mutual fund assets were held in tax-advantaged retirement plans as of the end of 2009. *See* 2010 ICI FACT BOOK, *supra* note 6, at 112.

385 *See* Comment Letter of The Spark Institute, Inc. (July 17, 2007).

386 *See* Roundtable Transcript, *supra* note 109, at 79 (Charles P. Nelson, Great-West Retirement Services).

387 *See* Deloitte Consulting LLP, Inside the Structure of Defined Contribution / 401(k) Plan Fees: A Study Assessing the Mechanics of What Drives the 'All-In' Fee (Spring 2009 – updated June 2009) (conducted by Deloitte Consulting LLP for the ICI) (http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf) (noting portions of the distribution fee may be used to compensate financial intermediaries and service providers for services provided to the plan and its participants and to offset recordkeeping and administration costs). To the extent that plan administrators receive these fees as compensation for the sale of fund shares, broker-dealer registration may be required unless an exemption is available. *See supra* note 168. As discussed

paying these expenses. Some funds may specifically identify operational costs and pay them outside of rule 12b-1.[388] Other funds might, for convenience, use 12b-1 fees to pay all of these expenses to avoid the need to determine exactly which of the expenses contribute to fund distribution.[389]

According to the Investment Company Institute, retirement plan assets are typically invested in low cost funds.[390] Approximately 80 percent of 401(k) plan assets are held in mutual fund share classes that pay no 12b-1 fees or 12b-1 fees of 25 basis points or less.[391] If our proposals are adopted, we would therefore expect that funds could continue to make the payments from the proceeds of the marketing and service fee.

Some funds with higher 12b-1 fees may identify a portion of those expenditures as not distribution related and treat them accordingly, and may thus be able to reduce their distribution related payments so that they do not exceed the limits of the marketing and service fee. As a result, these funds would not be subject to the ongoing sales charge limits discussed above. Other funds, however, may be required by our rule proposals to treat a portion of their 12b-1 fee as an ongoing sales charge and provide for a conversion period. We understand that many plan administrators currently do not track and age shares both because plan beneficiaries do not pay

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previously, broker-dealer registration would be required if a plan administrator received the proceeds of an "ongoing sales charge" under the proposal.

388 *See* THOMAS P. LEMKE & GERALD T. LINS, MUTUAL FUNDS SALES PRACTICES § 5:1 (Aug. 2009) (noting that third-party services in retirement plans may be paid by employer subsidies, direct charges to employees, or fees included in mutual fund expenses, such as rule 12b-1 fees and service fees).

389 *See* Paul G. Haaga, Jr. & Michele Y. Yang, Practicing Law Institute, *Distribution of Mutual Fund Shares: Rule 12b-1*, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES (June 1998) (indicating that rule 12b-1 fees may cover things that are not purely "sales" or "distribution" and pointing out that many fund groups subsidize the cost of 401(k) recordkeeping).

390 *See* ICI, *The Economics of Providing 401(k) Plans: Services, Fees and Expenses, 2008* (Aug. 2009) (http://www.ici.org/pdf/fm-v18n6.pdf).

391 *See id.* at 9.

taxes on capital gains realized on sales of shares in retirement plans and because many (or most) plans do not offer share classes that impose CDSLs.[392] Plan administrators would have to either develop this capability, which most other intermediaries have, or offer only classes of shares that do not impose an ongoing sales charge, *i.e.*, classes of shares that carry an asset-based distribution fee of only 25 basis points or less.[393]

A small number of funds today issue a class of shares created especially for retirement plans, often called "R shares." R type shares typically carry a 12b-1 fee of 50 to 100 basis points that generates sufficient revenue to pay for a substantial amount of plan expenses. The Commission staff estimates that less than two percent of plan assets are invested in R shares.[394] Treating amounts deducted in excess of 25 basis points as an ongoing sales charge and eventually converting these shares may not be a viable option for retirement plans with R share classes because plan expenses are ongoing. Thus, our proposal would likely make R shares a less attractive investment option for plans to offer.

We request comment on the potential consequences of our rule proposals on R shares, and whether investors would be harmed.[395] We also note that public policy, as embodied in the

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392 *See* Comment Letter of Charles P. Nelson (June 19, 2007) ("B and C shares usually aren't used by group retirement plan platforms due to the back-end loads that are assessed, which cause recordkeeping problems at the participant level."). Some retirement plans do, however, invest in share classes that require the tracking of share lots. *See* The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, *supra* note 390 at Appendix (the ICI estimates that approximately one percent of 401(k) assets invested in mutual funds are invested in class B shares). We also understand that in light of rule 22c-2, some plan administrators now track the holding periods of fund shares to ensure that redemption fees are properly assessed.

393 This issue is also raised in the context of insurance company separate accounts, as discussed in Section III.H of this Release, *supra*. We discuss the potential costs of implementing a conversion feature in Section V of this Release, *infra*.

394 The staff's estimate is based in part on information obtained from Lipper's LANA Database.

395 We believe that our proposal will complement disclosure initiatives proposed by the Department of Labor ("DOL"), which were designed to ensure that retirement plan participants and beneficiaries could make informed investment decisions about their retirement savings. Fiduciary Requirements

securities laws we administer and the laws administered by other agencies, favors transparency of expenses.[396]

- Do R share classes subsidize significant plan expenses or obscure plan costs by bundling them with mutual fund costs? Are R shares most attractive to plan sponsors that either are unable or choose not to bear plan expenses as an employee benefit? Does this tend to obscure that plan participants are paying the costs themselves through their investments? Do payments to plan administrators from the proceeds of 12b-1 fees on R shares pay for services that may not be exclusively attributable to the funds in which those assets are invested? If so, then are fund assets potentially being used to pay for services to non-fund investors (*i.e.*, not for exclusive benefit of fund investors)?[397]

N. Transition

If we adopt the rule and amendments we are proposing today, we expect to provide for a transition period in order to minimize disruption and costs to funds, fund shareholders, and those who participate in the distribution of fund shares.

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for Disclosure in Participant-Directed Individual Account Plans, 73 FR 43014 (July 23, 2008). The proposed DOL regulation would require, among other things, enhanced disclosure of the fees and expenses of certain retirement plans and their investment options. *Id.*

396 *See, e.g.*, Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001, *et seq.*); U.S. Dept. of Labor, Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure (Dec. 7, 2007) [72 FR 70988, 70995 (Dec. 13, 2007)]. *See also* U.S. Dept. of Labor, Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure (July 6, 2010) [75 FR 41600 (July 16, 2010] (interim final rule).

397 We understand that representatives from the fund industry have asserted that because the *plan* rather than plan participants is the legal owner of the fund shares, the use of plan assets will exclusively benefit the fund shareholder. This reliance on legal ownership is, however, inconsistent with the justifications given for the use of fund assets to pay for sub-accounting, transfer agency and other plan expenses. If the plan is the owner for purpose of this analysis, then only the cost of effecting plan transactions and maintaining records (and not transactions of plan beneficiaries) would be legitimate fund expenses.

1. Effective Date

We would expect to provide for an effective date within 60 days of issuing a release adopting the proposed amendments, which would permit (but not require) funds to take advantage of the new rules quickly.

- We request comment on the effective date.

2. Compliance Period

We would anticipate providing a compliance period of at least 18 months after the effective date in the adopting release for funds to come into compliance with rule 12b-2, amended rule 6c-10, and the other amendments, for new shares sold. Although we want to provide fund shareholders with the benefits we believe will be afforded by the rule amendments as soon as possible, we are sensitive to the operational consequences of the changes we are proposing, and the potential complexities of altering existing fund distribution arrangements. We believe a period of 18 months should be sufficient for funds and fund managers to make the necessary changes to their operating systems, distribution and other agreements, and registration statements.

- We request comment on the length of the compliance period, particularly in light of the "grandfathering" provisions we describe below.

3. Grandfathering

a. <u>Grandfathered Classes and Shares</u>

Five-year grandfathering period. Under our proposal, funds would be required to comply with the changes discussed above with respect to all shares issued after the compliance date of the new rules. We would provide a five-year grandfathering period after the compliance date for share classes issued prior to the compliance date, and that deduct fees pursuant to rule

12b-1 as it exists today, after which those shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge.[398] New sales would not be permitted in grandfathered share classes after the compliance date of the new rules.[399]

We are proposing this five-year grandfathering period so that investors, including those in classes currently subject to rule 12b-1 plans, would benefit from the protections provided by the proposed new rules. The grandfathering period is also designed to avoid unnecessarily disrupting existing distribution arrangements under which fund underwriters may have advanced commissions to pay dealers who have sold fund shares, and who may depend upon cash flow from existing rule 12b-1 fees. The five-year grandfathering period would provide time for funds and dealers to revisit and revise existing arrangements to reflect the approach to asset-based distribution fees we are proposing today. This period could allow the existing 12b-1 classes to wind down in an orderly manner. The five-year period is designed to allow sufficient time for funds and their boards to institute any necessary conversion or exchange procedures, and prepare to transition all remaining assets out of grandfathered 12b-1 classes.

We request comment on the proposed grandfathering period for the transition of existing shares into shares that comply with any new rules we adopt.

- Does this approach make sense in light of the compelling need for the regulatory changes we have discussed in this Release? Should we not provide a grandfathering period and instead require compliance immediately? Should we provide a shorter or longer period than five years (*e.g.*, one, three, eight, or ten years)? Instead of a five-

[398] Proposed rule 12b-2(d).

[399] Dividends or other distributions on the old shares, however, could be reinvested in the same share class as the shares on which the dividend or distribution was declared. These investments are not considered "sales" of securities for purpose of the Securities Act and this grandfathering provision. *See* Interpretation of the Division of Corporation Finance Relating to Dividend Reinvestment and Similar Plans, Securities Act Release No. 5515 (July 22, 1974), 4 SEC Docket 623 (Aug. 6, 1974).

year grandfathering period, should we permit the grandfathering of 12b-1 share classes to continue indefinitely?

- Should the proposed grandfathering period apply only to certain types of classes, such as "level load" share classes, and not apply to other classes, permitting them to convert on their own schedules? What benefits might result from such an approach? Should the proposed grandfathering period apply only to classes that charge a certain level of 12b-1 fees (*e.g.*, 12b-1 fees greater than 50 or 75 basis points)?

Alternative transition approaches. We also request comment on alternative approaches to carrying out the transition of existing share classes into classes that comply with any new rules we adopt.

- Should we adopt a "sunset" provision requiring that, by a certain date in the future, all share classes that do not conform to the new rules must be converted or exchanged into share classes that do conform to the new rule? Should we require, in connection with this approach, that shares in an existing fund class that are charged 12b-1 fees at a certain rate per annum be converted or exchanged into shares of a class that are charged a total of marketing and service fees and ongoing sales charges at the same or lower rate per annum? For example, under this approach, shares in an existing class that are currently charged a 12b-1 fee of 100 basis points would have to be converted or exchanged into a class that charges a marketing and service fee of no more than 25 basis points, and an ongoing sales charge of no more than 75 basis points for a limited time period. Should such an approach also take into account the existence of contingent deferred sales loads in existing classes or classes into which shareholders may be converted or exchanged?

- In addition, if we were to adopt this approach, when should we require that all fund shares be converted or exchanged into shares that comply with the new rules? By the compliance date of the rules (*i.e.*, 18 months), or within a shorter period (*e.g.*, six months or one year) or longer period (*e.g.*, two, three, five or seven years) of time? Should we exclude from the sunset provision any shares (such as certain B shares) that by their terms already convert automatically into shares with no ongoing sales charge?
- We request comment whether certain share classes would encounter special difficulty in complying with the proposed five-year transition period. For example, R share classes (which often charge a 50 basis point asset-based distribution fee for an indefinite period) may not be designed to convert to another class, and are often structured to pay certain costs that might otherwise be paid by the plan provider or the plan participants. If these classes are required to transition into a class that does not charge an ongoing sales charge after five years, this may result in a situation in which fees used to pay for these services may no longer be available. However, as discussed previously, this situation could also arise after the conversion period of an ongoing sales charge R share class under our proposal.[400] Does the proposed grandfathering period pose any special issues for certain share classes? If so what type of issues, and how should we deal with them? Should we exempt any funds or share classes from the requirement to eventually end existing 12b-1 share classes? Should we provide different grandfathering periods for different funds or classes? If so, how should we identify and define those funds or classes?

[400] *See supra* Section III.M.5.

- Should we take another approach to dealing with the problem of old 12b-1 share classes other than grandfathering or a sunset provision, and if so what should that approach require? Should we instead require funds to make special exchange offers to shareholders of old classes?

Funds could comply with the new rules by adding a conversion feature to newly issued shares. These funds would disclose in their prospectuses that shares issued before a specified date (the compliance date or earlier) will not convert on the same schedule as new shares would convert.

- Would this approach confuse shareholders? If so, should we require that shares offered under the new rules be issued in a separate class from grandfathered shares?

b. Operation of Grandfathered Classes

During the grandfathering period, under proposed rule 12b-2(d), funds could continue to charge 12b-1 fees on grandfathered share classes at the same (or lower) rate as was approved in the fund's 12b-1 plan.[401] A fund that wants to increase the rate of distribution fees, as a result, would have to comply with the proposed new rules. Because the level of fees charged on old share classes could not be increased, we do not believe any investor protection purpose would be served by requiring these funds to continue to have a formal 12b-1 plan, if we adopt these proposed rules. Thus, directors could eliminate mandatory provisions of 12b-1 plans that require board annual approval, quarterly reports, and allow for board or shareholder termination of plans.[402] Directors would continue to exercise responsibility over the 12b-1 plans in accordance with their general oversight responsibilities. In addition, pursuant to their broad authority, directors could terminate the plan at any time.

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[401] Proposed rule 12b-2(d)(2).

[402] Proposed rule 12b-2(d)(1).

After the expiration of the proposed grandfathering period, grandfathered shares would be required to be converted or exchanged into a class of shares that does not charge an ongoing sales charge. We are concerned that permitting the deduction of an ongoing sales charge on grandfathered fund shares could continue to result in shareholders overpaying for distribution. In addition, it may lead to operational and administrative difficulties in identifying the asset-based distribution fees that the shareholders may have already paid and providing proper credit for these fees. Not permitting the deduction of ongoing sales charges on grandfathered shares that have been exchanged or converted is likely to reduce investor confusion and provides equal treatment to investors.

Because under both rule 12b-1 and our proposal a shareholder vote is required to materially increase the rate of a 12b-1 fee, we would also require that the marketing and service fee of the class that the grandfathered shares are exchanged or converted into not be higher than the 12b-1 fee charged on the shares in the last fiscal year. This is designed to ensure that shareholders are not transitioned into a class that charges higher asset-based distribution fees than they agreed to when they originally bought the fund.

We request comment on any aspect of the proposed grandfathering provision.

- Should we require that directors continue to have specific, annual approval duties pursuant to existing rule 12b-1 until those fees are no longer collected? Should the rule provide further flexibility in addition to what we propose? We request comment on how grandfathered 12b-1 fees should be presented in the prospectus fee table. Should classes with grandfathered 12b-1 fees be required to separate and label their distribution fees just as they would under our proposed amendment to the fee table (*i.e.*, by assigning the first 25 basis points charged as a marketing and service fee and the remainder as an ongoing sales charge)? Is there another label for grandfathered 12b-1 fees that would be descriptive without a reference to "12b-1"?

- Instead of providing requirements regarding which class grandfathered shares would need to be transitioned into after the expiration of the grandfathering period, should we instead leave the decision to the discretion of the board? If so, should we provide any guidance to the board, and what should that guidance provide? For example, should we require that the board take into account the length of time that the grandfathered shares have already paid 12b-1 fees, the rate of the ongoing sales charge that might be charged, the technical capabilities of the fund and its service providers, or other factors?

4. Shareholder Voting

For funds that decide to convert current 12b-1 share classes to conform with the proposed rules, proposed rule 12b-2 would prohibit a fund from instituting a marketing and service fee unless the fee has been approved by a vote of at least a majority of outstanding voting securities.[403] A shareholder vote would not be required if the fund: (i) currently deducts from fund assets annual 12b-1 fees of 25 basis points or less, and does not increase the rate of the fee; or (ii) reduces the amount of the 12b-1 fees it currently deducts to an annual rate of 25 basis points or less, and renames the 12b-1 fee a "marketing and service fee." We understand that approximately two-thirds of fund classes either do not deduct a 12b-1 fee, or deduct a 12b-1 fee of 25 basis points or less annually. The proposed rule also would not require funds that currently impose a 12b-1 fee to obtain shareholder approval if the combined ongoing sales charge and marketing and service fee would not exceed amounts that could be deducted under a 12b-1 plan

[403] *See* proposed rule 12b-2(b)(3).

in effect at the time the proposed amendments, if adopted, become effective. In those instances, funds only would be required to separate the 12b-1 fee into a marketing and service fee and an ongoing sales charge, and treat each fee in conformity with the new rule and rule amendments.

We believe that, in the circumstances described above, a shareholder vote would serve no useful purpose because shareholders have already implicitly approved the fee, and a shareholder vote would thus impose unnecessary costs on funds and their shareholders.

- We request comment on whether a shareholder vote would serve any purpose in either of these situations.

IV. PAPERWORK REDUCTION ACT

Certain provisions of our proposal would result in new or altered "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[404] The Commission is therefore submitting proposed rule 12b-2 and proposed amendments to rule 6c-10 and Form N-SAR under the Act; proposed amendments to Forms N-1A and N-3 under the Act and the Securities Act; and proposed amendments to Schedule 14A and rule 10b-10 under the Exchange Act to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. Responses to the collection of information requirements of our proposals would not be kept confidential.

The proposed amendments to rule 6c-10 would result in a new collection of information requirement within the meaning of the PRA. The title for the collection of information requirement is "Rule 6c-10 under the Investment Company Act of 1940, 'Exemptions for Certain Open-End Management Investment Companies to Impose Deferred Sales Loads and Other Sales Charges.'" If adopted, this collection would not be mandatory, but would be required in order

[404] 44 U.S.C. 3501-3520.

for a fund to deduct asset-based distribution fees in excess of the proposed limits in rule 12b-2.

Proposed rule 12b-2 would result in a new collection of information requirement within the meaning of the PRA. The title for the collection of information requirement is "Rule 12b-2 under the Investment Company Act of 1940, 'Investment Company Distribution Fees.'" If adopted, this collection would not be mandatory, but would be required in order for funds to deduct certain asset-based distribution fees. In addition, our proposal would rescind rule 12b-1 and its associated collection of information requirement. We are submitting to OMB the proposed rescission of rule 12b-1's collection of information requirement.

The Commission is also proposing amendments to existing collection of information requirements titled "Form N-1A under the Investment Company Act of 1940 and Securities Act of 1933, 'Registration Statement of Open-End Management Companies.'" Compliance with the disclosure requirements of Form N–1A is mandatory. The Commission is also proposing amendments to existing collection of information requirements titled "Form N-3 under the Investment Company Act of 1940 and Securities Act of 1933, 'Registration Statement of Separate Accounts Registered as Management Investment Companies.'" Compliance with the disclosure requirements of Form N-3 is mandatory. The Commission is also proposing amendments to existing collection of information requirements titled "Form N-SAR under the Investment Company Act of 1940, 'Semi-Annual Report for Registered Investment Companies.'" Compliance with the disclosure requirements of Form N-SAR is mandatory. The Commission is further proposing amendments to existing collection of information requirements titled "Regulation 14A under the Securities Exchange Act of 1934 and the Investment Company Act of 1940, 'Commission Rules 14a-1 through 14a-16 and Schedule 14A.'" Compliance with the disclosure requirements of Regulation 14A is mandatory. The Commission is also proposing amendments to existing collection of information requirements titled "Rule 10b-10." Compliance with the disclosure requirements of rule 10b-10 is mandatory.

Finally, the Commission is also proposing a number of technical and conforming amendments that would not amend the existing collection of information burdens for rules 11a-3, 17a-8, 17d-3, and 18f-3 under the Investment Company Act, and Forms N-4 and N-6, and Regulation S-X under the Securities Act and the Investment Company Act. These technical and conforming amendments would not constitute new or altered collections of information because they would not alter the legal requirements of these rules and forms.[405] We estimate that the approved burdens for these rules and forms would not change if our proposal is adopted.

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. OMB has not yet assigned control numbers to the new collections for proposed rule 12b-2 and amended rule 6c-10. The approved collection of information associated with Form N-1A, which would be revised by the proposed amendments, displays control number 3235-0307. The approved collection of information associated with Form N-SAR, which would be revised by the proposed amendments, displays control number 3235-0330. The approved collection of information associated with Form N-3, which would be revised by the proposed amendments, displays control number 3235-0316. The approved collection of information associated with Schedule 14A, which would be revised by the proposed amendments, displays control number 3235-0059.

[405] As discussed in the cost-benefit analysis in Section V of this Release, *infra*, we have estimated that complying with these amended rules and forms would take the same amount of time and cost the same amount of money as complying with the existing rules and forms, with the exception of rule 11a-3. The additional costs that the staff has estimated that funds may incur as a result of our proposed amendments to rule 11a-3 are not related to collections of information in the rule (certain disclosure, recordkeeping, and notice requirements), but are instead a result of system changes that funds may undertake. As a result, we do not expect that these proposed technical and conforming rule and form amendments would change existing approved collection of information burdens for any of these rules and forms.

The approved collection of information associated with rule 10b-10, which would be revised by the proposed amendments, displays control number 3235-0444.

A. Rule 6c-10

Proposed rule 6c-10(c) would give funds and their underwriters the option of offering classes of shares that could be sold by dealers subject to competition in establishing sales charge rates. A fund could rely on this provision if it discloses its election on Form N-1A. This disclosure would be a collection of information within the meaning of the PRA. The collection of information for rule 6c-10(c), however, is incorporated into the total collection of information burden for our amendments to Form N-1A, discussed below. As a result, the collection of information burden for proposed rule 6c-10(c) is not a separate collection of information within the meaning of the PRA.

B. Rescission of Rule 12b-1

We are proposing to rescind rule 12b-1. If adopted, the rescission would eliminate the current collection of information requirement for rule 12b-1 in its entirety. Therefore, there would no longer be a collection of information burden for rule 12b-1.

C. Rule 12b-2

Proposed rule 12b-2(b) would permit funds to deduct a "marketing and service fee" from fund assets that is limited to the maximum rate permitted by NASD Conduct Rule 2830 for "service fees." In order to institute or increase the rate of a marketing and service fee after the initial public sale of class shares, proposed rule 12b-2(b)(3) would require a fund to obtain approval from a majority of the class's shareholders. As under proposed rule 6c-10(b)(3), funds would obtain shareholder approval by soliciting proxies from shareholders, which would be a collection of information under the PRA on Schedule 14A under the Exchange Act. As noted above, Schedule 14A has an approved collection of information which our proposed amendments would change. As a result, the collection of information burden for proposed rule 12b-2(b)(3) is not a separate collection of information, but is incorporated into the estimated paperwork burden for Schedule 14A.

Proposed rule 12b-2(c) would maintain the restrictions in current rule 12b-1(h) that prohibit funds from using brokerage commissions to finance distribution. Among other things, proposed rule 12b-2(c) would maintain the requirement that a fund (and its board of directors) approve policies and procedures designed to prevent: (i) the persons responsible for selecting brokers and dealers to effect the fund's portfolio securities transactions from taking into account the brokers' and dealers' promotion or sale of shares issued by the fund or any other registered investment company; and (ii) the fund, or any investment adviser or principal underwriter of the fund, from entering into any agreement or other understanding under which the fund directs portfolio securities transactions to a broker or dealer to pay for the distribution of fund shares. The requirement to adopt these policies and procedures would be a collection of information under the PRA, and would be mandatory in order to direct brokerage transactions to a broker or dealer that distributes fund shares. The Commission has determined that these collections of information would continue to be necessary to protect against the inappropriate use of fund assets to finance distribution, and would continue to be used by the Commission and its examination staff to monitor these activities.

As discussed in the most recent PRA update to rule 12b-1, we understand that funds (if they intend to pay brokerage commissions to brokers and dealers who distribute their shares) generally adopt these policies and procedures when the fund is created, and incur any burden associated with this collection of information at that time. We assume that all funds that are currently operating have already adopted these policies and procedures (if relevant), and therefore only new funds that begin to operate in the future will incur this burden. As previously estimated in the most recent update to the rule 12b-1 PRA, the staff estimates that approximately 300 new funds would begin operations annually that would comply with proposed rule 12b-2(c) and adopt these policies and procedures. Based on information received during conversations with fund representatives, the staff estimates that adopting these policies and procedures would take a total of approximately 1 hour of the board of directors' time as a whole, at an internal time cost equivalent rate of $4500 per hour.[406] The staff further estimates that preparing these policies and procedures for adoption would take approximately 3 hours of internal fund counsel time, at an internal time cost equivalent rate of $316 per hour.[407] Finally, the staff estimates that it would cost funds approximately $800 in outside counsel time (2 hours multiplied by an estimated $400 per hour for outside counsel time)[408] to adopt these policies and procedures.

Therefore, the collection of information related to adopting directed brokerage policies and procedures pursuant to proposed rule 12b-2(c) would require a total annual burden of 300 hours of director time (at a total internal time cost equivalent of $1,350,000),[409] 900 hours of

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406 The staff has estimated the average cost of board of director time as $4500 per hour for the board as a whole, based on information received from funds, intermediaries, and their counsel.

407 The staff estimates that the internal time cost equivalent for time spent by internal counsel is $316 per hour. This estimate, as well as all other internal time cost estimates made in this analysis (unless otherwise noted) is derived from SIFMA's *Management & Professional Earnings in the Securities Industry 2009*, 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 or from SIFMA's *Office Salaries in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

408 The staff has estimated the average cost of outside counsel as $400 per hour based on information received from funds, intermediaries, and their counsel.

409 This estimate is based on the following calculations: (1 hour of directors time × 300 newly formed funds = 300 hours); (300 hours × $4500 per hour = $1,350,000).

inside counsel time (at a total internal time cost equivalent of $284,400),[410] and $240,000 in outside counsel expenses.[411] The total annual number of respondents would be 300, the total number of responses would also be 300, and the annual burden per respondent would be 4 hours and $800 in costs.

- We request comment on these estimates and assumptions. If commenters believe these estimates and assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

D. Form N-1A

Form N-1A is the form that funds use to register with the Commission under the Investment Company Act and to offer their shares under the Securities Act.[412] As discussed previously, the proposed amendments would require funds that file Form N-1A to: (i) eliminate the line item currently titled "Distribution and/or Service (12b-1) Fee" and include two new line items (as relevant) titled "Marketing and Service Fee" and "Ongoing Sales Charge;" (ii) revise prospectus narrative disclosure on asset-based distribution fees; and (iii) revise the SAI disclosure regarding asset-based distribution fees. The Commission believes that these changes in the collection of information should better enable fund investors to understand the purpose and use of the asset-based distribution fees that they may pay. These changes will be used to better monitor and oversee the use of asset-based distribution fees by funds, and assist investors in obtaining information about the use of fund assets. Preparing Form N-1A is a collection of

[410] This estimate is based on the following calculation: (3 hours of inside counsel time × 300 newly formed funds = 900 hours); (900 hours × $316 per hour = $284,400).

[411] This estimate is based on the following calculation: ($800 cost of outside counsel time × 300 newly formed funds = $240,000).

[412] There are two types of Form N-1A filings: (i) initial filings; and (ii) annual post-effective amendments. Funds usually incur significantly more time and incur greater costs when first registering a fund under their initial N-1A filings than when filing their annual post-effective updates. Therefore, we separately estimate the burden for each type of filing.

information under the PRA and is mandatory.

1. New Defined Term

The proposed amendments would add the defined term "Asset-Based Distribution Fee" to the general instructions of Form N-1A.[413] This term would be used in other parts of our proposed amendments to the form. The additional definition would not affect the form's collection of information requirements and therefore would not change current paperwork burden estimates.

2. Revised Fee Table

The proposed amendments would require funds, in the fee table of Form N-1A, to replace the current line item titled "Distribution and/or Service (12b-1) Fees" with two line items titled "Marketing and Service Fee" and "Ongoing Sales Charge," as relevant. Only funds that charge asset-based distribution fees would be affected by these proposed amendments. Funds would be able to refer to the same information about asset-based distribution fees that they use to complete the 12b-1 line item currently in the fee table. All information necessary to disclose these fees in the fee table would be readily available, and the staff estimates that funds would not require any additional resources to disclose the fees on two lines, instead of one. Therefore, the staff estimates that funds would not incur any additional hourly burdens or costs to complete the fee table as we propose to amend it. As a result, the staff estimates that the proposed amendments to the fee table would not change the collection of information currently approved by OMB to complete the fee table in Form N-1A, either initially or when submitting a post-effective amendment.

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[413] The proposal would define an "Asset-Based Distribution Fee" as "a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b) ("Marketing and Service Fee"), rule 12b-2(d), or rule 6c-10(b) ("Ongoing Sales Charge")." Proposed General Instructions to Form N-1A.

- We request comment on these assumptions. If commenters believe these assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

3. Prospectus Revisions

The proposal would amend Item 12(b) of Form N-1A, which currently requires funds that have adopted 12b-1 plans to disclose information about the operation of the plan in the prospectus. The proposal would eliminate this requirement, and instead require funds to disclose whether they charge a marketing and service fee or an ongoing sales charge, and if they do, to disclose the rate of the fees and the purposes for which they are used. A fund that imposes an ongoing sales charge would be required to disclose the number of months (or years) before the shares would automatically convert to another class without an ongoing sales charge. In addition, we would require a fund offering multiple classes of shares in a single prospectus (each with its own method of paying distribution expenses) to describe generally the circumstances under which an investment in one class may be more advantageous than an investment in another class.

Based on information received during conversations with fund representatives, the staff estimates that funds filing initial Form N-1A registrations would expend approximately the same amount of time and costs to provide the narrative prospectus disclosure on asset-based distribution fees under our proposal as they expend under the current disclosure requirements.

The proposed amendments would also require funds that deduct asset-based distribution fees to revise their narrative prospectus disclosure in post-effective amendments. The staff further estimates that the funds would need to incur a one-time cost and time expenditure to revise and update existing narrative prospectus disclosure to comply with the proposal. After this one-time revision and update is complete, the staff estimates that ongoing costs and time expenditures would remain the same as current estimates because we expect the revised disclosures to be of similar length and complexity as the previous disclosure. The staff expects that the revised narrative prospectus disclosure would be similar in length to the current narrative, and thus would not change the number of pages in the prospectus or change printing costs of the prospectus.[414] The staff estimates that funds would use outside legal resources to prepare this one-time amendment to reflect the proposed new framework. The staff expects that all funds in a fund family would engage in this one-time update at the same time, and therefore the costs for revising a series prospectus would be shared among all funds in the family, thereby reducing the cost for each post-effective update filer. Based on an analysis of data received on Form N-SAR and information received from fund representatives, the staff estimates that there are approximately 379 fund families that may be affected by this proposed change. The staff further estimates that, on average, each of these fund families would incur approximately $2000 in one-time costs (for outside legal counsel drafting and review) and expend 10 hours in internal personnel time (at an internal time cost equivalent rate of $316 per hour) to revise item 12(b) of Form N-1A to comply with the proposed changes. The staff therefore estimates that funds will incur a one-time burden of 3710 hours (at an internal cost equivalent of $1,197,640) and $758,000 in outside costs associated with this proposed revision to Item 12(b) of Form N-1A.[415] The staff estimates that the proposed amendments would not change the *ongoing* currently approved collection of information for Item 12(b) of Form N-1A.

- We request comment on these estimates and assumptions. If commenters believe

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[414] Based on conversations with fund representatives, the staff understands that, in general, unless the page count of a prospectus is changed by at least 4 pages, the printing costs would remain the same.

[415] These estimates are based on the following calculations: (379 x 10 hours = 3790 hours); (3790 hours x $316 per hour = $1,197,640); (379 x $2000 = $758,000).

these estimates and assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

4. Statement of Additional Information

The proposal would amend a number of items contained in the SAI portion of Form N-1A. Item 19(g) currently requires funds to describe in detail the material aspects of their 12b-1 plans, and related agreements, in the SAI. Under the proposal, 12b-1 plans would no longer be required, and grandfathered funds would no longer be required to have written "plans" that are supervised and approved by the board of directors; therefore, the proposal would eliminate paragraphs 2 through 6 of Item 19(g).[416] However, Item 19(g)(1) (which requires disclosure of the material aspects of a 12b-1 plan, including a list of the principal activities paid for under the plan and the dollar amounts spent on each activity over the last year), may help investors to better understand how the fund uses asset-based distribution fees, and the proposal would retain it in substance. The proposal would amend Item 19(g)(1) to eliminate references to a 12b-1 plan, and instead require disclosure of the principal activities paid for through asset-based distribution fees (both ongoing sales charges and marketing and service fees).

The proposal would add new paragraph (d) to Item 25, which would require funds that have elected to externalize the sales charge pursuant to proposed rule 6c-10(c) to disclose this election on Form N-1A. This disclosure is designed to inform interested investors of the fund's election. The proposal would also make technical conforming changes to Instruction 3(b) to Item 3; Instruction 5 to Item 26(b)(4); and Item 27(d)(1) (and Instruction 2(a)(i) to Item 27(d)(1)) to replace references to 12b-1 fees and plans with references to the appropriate types of asset-based distribution fee under the proposal. Finally, the proposal would eliminate existing

[416] *See supra* note 313 and accompanying text.

Item 28(m) of Form N-1A, which requires a fund to attach its rule 12b-1 plan and any related agreements as an exhibit to its registration statement. The exhibit would be unnecessary because proposed rule 12b-2 does not require a written plan.

The staff estimates that the proposed amendments to the SAI would result in overall time and cost savings for funds. Funds would incur savings because of the reduced time required and lower costs to prepare disclosure materials for Item 19(g).[417] The staff further estimates that responding to proposed paragraph (d) of Item 27 would entail little additional time and no costs, as it would only require a fund to make a single affirmative statement (if applicable) that the fund has taken the election. The staff estimates that the other proposed technical and conforming amendments to the SAI would not result in changes in the hourly burdens or cost because they would not change the legal or disclosure obligations of funds.

Therefore, based on conversations with fund representatives, the staff estimates that the proposed amendments to the SAI would result in a *net* time savings of approximately 10 hours for each fund's initial filing and of 1 hour for each post-effective amendment (all of which time would be spent by fund counsel at a time cost equivalent rate of $316 per hour). Based on a review of information filed with the Commission on Form N-SAR, the staff estimates that there are approximately 300 funds with a 12b-1 plan that newly file each year and 7367 funds that have adopted a 12b-1 plan that file post-effective amendments. The staff further estimates that the amendments would reduce costs incurred for outside counsel associated with completing the SAI, by $500 for each initial filing and $150 for each post-effective amendment. Therefore, the

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417 Generally, most SAIs are not printed in advance, but are instead printed on demand when requested. The staff estimates that the proposal would not result in a change in printing costs because the staff does not expect that the number of pages of the SAI would be reduced as a result of the proposal, and if there were any reduction; any savings would be minimal due to the few occasions on which the SAI is printed.

staff estimates that all funds submitting their initial SAI filing would experience a reduction of 3000 hours (at an internal cost equivalent of $948,000) and a cost savings of $150,000.[418] The staff also estimates that all funds filing post-effective amendments will experience a reduction of 7367 hours (at an internal cost equivalent of $2,327,972) and cost savings of $1,105,050.[419]

5. *Change in Burden*

In the most recent Paperwork Reduction Act submission for Form N-1A, the staff estimated that for each fund portfolio or series, the initial filing burden is approximately 830.47 hours at a cost of $20,300, and the post-effective amendment burden is approximately 111 hours at a cost of $8894. This hourly burden includes time spent by in-house counsel, back office personnel, compliance professionals, and others in preparing the form. The costs include that of outside counsel to prepare and review these filings.

As discussed above, in total the staff estimates that our proposed amendments to Form N-1A would result in net time savings of approximately 10 hours for each fund's initial filing (for a new total estimate of 820.47 hours) and of 1 hour for each post-effective amendment (for a new total estimate of 110 hours).[420] The staff further estimates that the proposed amendments would reduce costs spent on outside counsel associated with completing Form N-1A, by $500 for each initial filing (for a new total estimate of $19,800) and $150 for each post-effective amendment (for a new total estimate of $8744). The staff also estimates that the proposed amendments would require each fund family with any funds that would file a post-effective

418 These estimates are based on the following calculations: (300 x 10 hours = 3000 hours); (3000 hours x $316 per hour = $948,000); (300 x $500 = $150,000).

419 These estimates are based on the following calculations: (7367 x 1 hours = 7367 hours); (7367 hours x $316 per hour = $2,327,972); (7367 x $150 = $1,105,050).

420 This is based on the estimates made previously in this section that there would be no burden change as a result of our proposed amendments to the prospectus portion of N-1A and that the proposed changes to the SAI portion would result in the savings indicated.

amendment to incur approximately $2000 in one-time costs and expend 10 hours in internal personnel time.

The staff assumes that only funds that charge asset-based distribution fees would be affected by our proposed amendments to Form N-1A and would realize these reduced burdens and cost savings. The staff estimates that, each year, there are approximately 7367 funds with 12b-1 plans that file post-effective amendments, and would therefore be affected by our proposed amendments. The staff estimates that an additional 300 funds with asset-based distribution fees would file an initial Form N-1A each year after our proposed amendments would go into effect. Based on these estimates, the staff estimates that funds would save a total of 3000 hours and $150,000 when submitting initial Form N-1A filings each year.[421] In addition, the staff anticipates that funds would save approximately 7367 hours, and $1,105,050 annually when preparing post-effective updates to Form N-1A.[422]

Finally, as discussed above, the staff further estimates that all fund families that file post-effective amendments and have adopted 12b-1 plans would incur a one-time burden of 3790 hours (at an internal cost equivalent of $1,197,640) and $758,000 in outside costs when preparing post-effective amendments to comply with the proposed amendments for the first time.[423]

- We request comment on any of these estimates or assumptions.

E. Form N-SAR

Form N-SAR is the form that registered investment companies use to make periodic

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[421] This is based on the following calculations: (300 new filers × 10 hours savings = 3000 hours in total savings); (300 new filers × $500 savings = $150,000 total savings).

[422] This estimate is based on the following calculations: (7367 amendments × 1 hour savings = 7367 hours in total savings); (7367 amendments × $150 savings = $1,105,050 total savings).

[423] These estimates are based on the following calculations: (379 x 10 hours = 3790 hours); (3790 hours x $316 per hour = $1,197,640); (379 x $2000 = $758,000).

reports to the Commission. Completing Form N-SAR is a collection of information under the PRA and is mandatory. Our proposed amendments would add an instruction to Form N-SAR to disregard, for funds that no longer have 12b-1 plans, four questions (Items 41-44) that relate to the operation of rule 12b-1 plans (because they would be irrelevant in light of our proposed new framework for asset-based distribution fees). However, funds that maintain grandfathered fund classes would continue to respond to these items.

The total annual hour paperwork burden estimate for Form N-SAR is 107,213 hours. The current approved total number of respondents is 4142, and the total annual number of responses is 7461.[424] The staff estimates that there are approximately 1292 management investment companies that respond to Items 40-44 of Form N-SAR.

The staff estimates that our proposed amendments would reduce the time it takes funds that do not have grandfathered share classes to complete Form N-SAR by 0.25 hours, and that there would be no change for funds that maintain grandfathered share classes. The staff estimates that, if these amendments are adopted, in the first three years after adoption, approximately 20% of these 1292 management investment companies (or 258) will no longer maintain grandfathered share classes and experience the estimated savings, while the remaining 80% (or 1034) will continue to have grandfathered share classes and respond to these items. Because Form N-SAR is completed twice a year, the staff estimates that each filer that no longer responds to these items would save approximately 0.5 hour annually (at an internal time cost equivalent rate of $316 per hour). The staff therefore estimates that our proposed amendments to Form N-SAR would result in an aggregate incremental time savings of approximately 129 hours

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[424] The staff estimates the number of filers and filings based on the actual number of EDGAR filings and on other Commission records.

(with a total internal time equivalent cost savings of $40,764)[425] annually compared to the current approved hour burden.

- We request comment on these estimates and assumptions.

F. Schedule 14A

Funds must comply with the requirements of Schedule 14A when they solicit proxies from their shareholders. Our proposal would amend the required disclosures under Schedule 14A when a fund seeks approvals from its shareholders to institute or increase the rate of a marketing and service fee after shares have been offered to the public. The proposed amendments would remove items regarding asset-based distribution fees that would be superfluous in light of our proposed rescission of rule 12b-1 and new rule and rule amendments on asset-based distribution fees, and would amend certain other items.

Based on conversations with fund representatives and the most recent PRA update to Schedule 14A, the staff estimates that 75% of the burden of preparing Schedule 14A filings is undertaken by the fund internally and that 25% of the burden is undertaken by outside counsel retained by the fund at an average cost of $400 per hour.[426] The staff estimates that 3 funds would solicit proxies each year for the purposes of seeking approval to implement or increase a fee as required under proposed rules 6c-10(b)(3) and 12b-2(b)(3) (the same number that the staff has estimated would solicit proxies under rule 12b-1) because the staff believes the proposed amendments are unlikely to affect the number of funds that seek proxy approval from their shareholders. For each of these 3 funds, the staff estimates that our proposed amendments to Schedule 14A would create an incremental reduction in burden of 3 hours of fund personnel time

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425 This estimate is based on the following calculation: (258 × 0.5 hours = 129 hours); (129 hours × $316 per hour = $40,764).

426 This cost estimate is based on consultations with several registrants and law firms and other persons who regularly assist registrants in preparing and filing proxies with the Commission.

(at an internal time cost equivalent rate of $316 per hour) and reduced costs of $400 for the services of outside counsel, as a result of the proposed amended disclosures relating to marketing and service fees on Schedule 14A. The staff therefore estimates that these amendments would reduce the total annual paperwork burden of Schedule 14A by approximately 9 hours of fund personnel time (3 funds x 3 hours) at an internal time cost equivalent of $2844,[427] and by approximately $1200 (3 funds x $400) for the services of outside counsel.

In our most recent PRA submission for Regulation 14A (which includes Schedule 14A), the staff estimated that there are a total of 7300 respondents who use Schedule 14A, each of whom responds once a year, for a total of 7300 responses annually. The staff estimates that this number of respondents would remain the same under the proposed amendments because the staff does not expect our proposed amendments to affect the number of funds that seek approval from their shareholders to institute or increase marketing and service fees. The current approved aggregate time burden for these respondents is 669,026 hours and the cost burden is $78,822,387. The staff estimates that the proposed amendments would reduce this time burden by a total of 9 hours (3 hours times the 3 respondents affected by our proposed amendments) for a new total of 669,017 hours, and would reduce the cost burden by a total of $1200, for a new aggregate total of $78,821,187. This would represent an average per respondent time burden of 92 hours, and a cost burden of $10,797.[428]

- We request comment on these estimates and assumptions. If commenters believe these estimates and assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

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[427] This estimate is based on the following calculation: (9 hours × $316 per hour = $2844).

[428] This is based on the following calculations: (669,017 hours ÷ 7300 respondents = 92 hours); ($78,821,187 ÷ 7300 respondents = $10,797).

G. Form N-3

Form N-3 is the registration form used by insurance company separate accounts registered as management investment companies that offer variable annuity contracts.[429] The proposed amendments would require separate accounts that file Form N-3 to: (i) revise prospectus narrative disclosure on asset-based distribution fees; and (ii) revise the SAI disclosure regarding asset-based distribution fees. Preparing Form N-3 is a collection of information under the PRA and is mandatory.

The proposal would amend Instruction 2 to Item 7(a) of Form N-3, which currently requires registrants to list the principal types of activities for which 12b-1 payments are made and the total amount spent in the most recent fiscal year, as a percentage of net assets (or, if the plan has not been in effect for a full fiscal year, a description of the payments). The proposal would eliminate the requirement that registrants disclose the total amount spent in the most recent fiscal year, and instead require registrants to provide a description of asset-based distribution fees, as defined in the new proposed rule. The proposal would retain the requirement that registrants list the principal types of activities for which asset-based distribution fees are deducted.

As discussed above, funds would no longer be required to have written plans that are supervised and approved by the board of directors under our proposed rule amendments. Therefore, the proposal would eliminate paragraphs (ii) and (iii) of Item 21(f), which relate to the

[429] There are two types of Form N-3 filings: (i) initial filings; and (ii) annual post-effective amendments. Funds usually incur significantly more time and incur greater costs when first registering a fund under their initial N-3 filings than when filing their annual post-effective updates. Therefore, the staff separately estimates the burden for each type of filing.

specific operation of a 12b-1 plan.[430] Paragraph (i) of Item 21(f) requires registrants to disclose the manner in which amounts paid by the registrant under a 12b-1 plan were spent. We believe that the information required to be disclosed in paragraph (i) of Item 21(f) would continue to be useful to investors and the Commission. Therefore, we are proposing to amend Item 21(f) to require disclosure of the principal activities paid for through asset-based distribution expenses incurred under rule 12b-2(b) and (d) and rule 6c-10(b), deleting references to 12b-1 plans. For the reasons discussed above, we are also proposing to amend Instruction 5 to Item 26(b)(ii) to delete any references to 12b-1 plans. However, registrants would be required to provide the same information with respect to expenses and reimbursements accrued pursuant to rule 12b-2(b), rule 12b-2(d), and rule 6c-10(b).

The current approved aggregate time burden to comply with the collection of information requirements in Form N-3 is 13,024 hours. The current approved aggregate cost burden is $601,400.

Only registrants that charge asset-based distribution fees would be affected by our proposed amendments to Form N-3. Based upon a review of filings with the Commission, the staff estimates that 1 registrant that currently files on Form N-3 charges asset-based distribution fees, and would file a post effective amendment. Based upon conversations with fund representatives, the staff estimates that it would cost this registrant approximately $2000 in one-time costs (for outside legal counsel drafting and review) and require an expenditure of 10 hours in internal personnel time (at an internal time cost equivalent rate of $316 per hour) to revise its prospectus to comply with the proposed amendments. The staff further estimates, based on those

[430] Item 21(f)(ii) requires a registrant to disclose whether any interested person or director has a financial interest in the operation of the 12b-1 plan. Item 21(f)(iii) requires disclosure of the anticipated benefits of the plan to the fund.

conversations, that the proposed amendments to Item 21 and Instruction 5 of Item 26 would result in time savings when completing a post-effective amendment of a Form N-3 filing. The staff estimates that this registrant would save approximately 1 hour (at an internal time cost equivalent of $316 per hour) annually as a result of the proposed amendments.

The staff further estimates that no new registrants that file on Form N-3 are likely to charge asset-based distribution fees under proposed rule 12b-2 and the proposed amendments to rule 6c-10. Accordingly, the staff estimates that there will be no other changes in burden hours or costs for Form N-3 as a result of the proposed rule and rule amendments.

- We request comment on these estimates and assumptions.

H. Rule 10b-10

Rule 10b-10 requires broker-dealers to convey basic trade information to customers regarding their securities transactions. The proposed amendments would revise rule 10b-10 by requiring disclosure of additional information related to sales charges in connection with transactions involving mutual funds, requiring disclosure of certain additional information in connection with callable debt securities, and removing certain outdated transitional provisions from the rule. This collection of information would be mandatory. The information would be used by broker-dealer customers to evaluate the terms of their own securities transactions. In addition, the information contained in the confirmations may be used by the Commission, self-regulatory organizations, and other securities regulatory authorities in the course of examinations, investigations, and enforcement proceedings. No governmental agency regularly would receive any of this information.[431]

[431] Exchange Act Rule 17a-4(b)(1), 17 CFR 240.17a-4(b)(1), requires broker-dealers to preserve confirmations for three years, the first two years in an accessible place.

The proposed amendments to rule 10b-10, in part, would require transaction confirmations to disclose additional information about sales charges associated with purchases and redemptions of mutual fund shares. The purpose of these changes is to help make the confirmation a more complete record of the transaction, help mutual fund investors more fully understand the sales charges they pay, and assist investors in verifying whether they paid the correct sales charge as set forth in the prospectus. The proposed amendments to rule 10b-10 also would require confirmation disclosure of certain additional information about callable debt securities. The purpose of these proposed amendments is to provide investors with information necessary to evaluate their transactions involving callable debt securities, by helping to alert investors to misunderstandings, avoid confusion, promote the timely resolution of problems, and better enable investors to evaluate potential future transactions.[432]

The rule would apply to the approximately 5035 broker-dealers registered with the Commission. The Commission staff understands, however, that under the current industry practice confirmations are customarily generated and sent by clearing broker-dealers ("clearing firms") subject to agreements ("clearing agreements") with introducing broker-dealers ("introducing firms"). Under this industry practice, the Commission staff understands that clearing firms would bear most of the costs associated with updating back-office operations to accommodate the proposed changes to rule 10b-10.[433]

432 The proposal also would delete certain expired transitional provisions of rule 10b-10 related to securities futures products; there would be no burden associated with this deletion.

433 For purposes of this analysis, the staff assumes that all registered broker-dealers effect transactions in mutual fund shares. To the extent that some broker-dealers may not effect transactions in mutual fund shares, the paperwork burdens and costs may be overstated. Furthermore, for the purposes of this analysis, broker-dealers that have not entered into clearing agreements with introducing firms yet generate and send confirmations, are included as clearing firms in the staff's estimates.

Based on filings with the Commission, the staff estimates that of the 5035 broker-dealers registered with the Commission, approximately 530 are clearing firms. The Commission staff understands that approximately 30% of clearing firms, or 160 firms, have developed their own proprietary systems for generating and inputting the information necessary to generate and deliver a confirmation. The staff further understands that the other approximately 70% of clearing firms, or 370 firms,[434] license platforms from third-party service providers (or vendors) that, among other things, generate the data necessary to produce and send confirmations.[435]

Based on the industry's current practices, the staff understands that the 160 clearing firms with proprietary systems would have a one-time burden associated with reprogramming software and otherwise updating back-office systems and platforms to enable confirmation delivery systems to generate the information required under the proposed amendments.[436] The Commission staff further estimates, based on discussions with industry representatives, that this one-time programming burden for clearing firms with proprietary back-office systems would amount to, on average, approximately 4500 hours per clearing firm, for a total of 720,000 burden hours.[437]

With respect to clearing firms that license vendor platforms ("clearing firm licensees"), the staff estimates that these vendors will incur costs similar to those incurred by clearing firms with proprietary systems to reprogram and update their platform. Thus, staff estimates that the

434 The staff's understanding is that these firms are usually small and medium-sized clearing firms, but may also include some larger firms as well.

435 The staff's understanding is that there are three primary vendors that license platforms used by clearing firms to generate and send confirmations. In addition to licensing platforms, many clearing firms may also use vendors to separately print and mail confirmations to investors.

436 The staff notes that these estimates are based on the assumption that ongoing sales charges and marketing and service fees commonly will not change over time for any particular mutual fund. The staff also assumes that the information necessary to comply with the proposed changes to rule 10b-10 will be readily available to clearing firms from various third-party service providers.

437 160 clearing firms with proprietary systems x 4500 burden hours = 720,000 burden hours.

burden to vendors would be approximately 4500 burden hours per vendor, resulting in one-time costs to these vendors of approximately $3.4 million dollars.[438] Based on discussions with industry representatives, the staff also understands that clearing firm licensees would still incur approximately 800 burden hours per firm to adopt the changes to a vendor's platform and determine that the output satisfies the requirements of the proposed amendments to the rule. The staff estimates that the total burden for clearing firm licensees would be approximately 296,000 total hours.[439] When we sum the labor hours borne by clearing firms with proprietary systems with those borne by clearing firm licensees, we estimate that that the total one-time hour burden as a whole for entities registered with the Commission will be 1,016,000 burden hours.[440]

The Commission staff understands that once completed, this reprogramming and systems updating should permit clearing firms to have automated access to the additional information that would be disclosed in confirmations. Accordingly, the staff does not believe that there will be a material increase in the ongoing costs associated with producing and sending confirmations once the initial one-time reprogramming costs are completed.

I. Request for Comments

We request comment on whether the estimates provided in this PRA are accurate. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections

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438 3 vendors x 4500 burden hours x $251 dollars per hour = $3,388,500. The staff estimates per hour costs to be $251.

439 370 clearing firm licensees x 800 burden hours = 296,000 total burden hours.

440 (160 clearing firms with proprietary systems x 4500 burden hours) + (370 clearing firm licensees x 800 burden hours) = 1,016,000 total burden hours.

of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-15-10. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-15-10, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213.

V. COST-BENEFIT ANALYSIS

A. Background

The Commission is sensitive to the costs and benefits imposed by its rules. We recognize that if adopted, the proposed new rule and rule amendments would result in costs for some funds and other marketplace participants.[441] We have identified certain costs and benefits of the proposed rule and rule amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on our estimates of the costs and benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for funds and their intermediaries, including small entities, and for investors, as well as any other costs or benefits that may result from the adoption of the proposed rule and rule and form amendments.

The proposal is designed to protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate role for fund directors, and introduce greater competition among funds in setting sales loads and distribution fees generally. As discussed in greater detail above, we are proposing to: (i) rescind rule 12b-1 under the Act; (ii) adopt new rule 12b-2 under the Act, which would permit funds to deduct a marketing and service fee at a rate no greater than the maximum rate permitted as a service fee under the NASD sales charge rule (currently 25 basis points) annually; (iii) adopt amendments to rule 6c-10, which would permit funds to deduct asset-based sales charges in excess of the marketing and service fee in the form of an "ongoing sales charge" (up to certain limits); (iv) as an alternative to the ongoing sales charge, provide an elective alternative that would allow funds to sell their shares through intermediaries subject to competition in establishing sales charge rates; (v) amend

[441] Although we discuss many of these costs in terms of the fund, the preparation of these reports is most likely done by employees of the fund's adviser, because most funds do not have any employees of their own.

Form N-1A and N-3 under the Securities Act and the Investment Company Act, and Schedule 14A under the Exchange Act to reflect the proposed rule and rule amendments, (vi) make conforming amendments to rule 11a-3 under the Investment Company Act; and (vii) make technical amendments to rules 17a-8, 17d-3, and 18f-3, and Forms N-SAR, N-4 and N-6 under the Investment Company Act, and rule 6-07 of Regulation S-X under the Securities Act.

In general, for each aspect of the proposal, we have attempted to estimate the potential costs and benefits in dollars for each entity that may be affected. Some of the expected costs and benefits from our proposals cannot be measured in dollars, but are effects nonetheless, such as the benefits of improved investor understanding of distribution charges and the costs and benefits of greater equity in the cumulative amount of sales charges paid by individual investors. When actual dollar costs and benefits would likely result (such as from the elimination of certain disclosure requirements that would be eliminated under the proposal, such as descriptions of 12b-1 plans) we have estimated the relevant costs and savings.[442]

In this analysis, Commission staff has estimated the percentage of funds or other parties that are likely to change their operations in response to our proposal. These and other estimates and assumptions are based on interviews with representatives of funds, their intermediaries, investor advocates, and the experience of Commission staff. In addition, in preparing this cost-benefit analysis, Commission staff reviewed fund prospectuses, periodic reports made to the Commission pursuant to Form N-SAR and other fund filings, and a commercial database of information on funds.[443] Throughout this analysis, unless otherwise stated, the estimates are

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442 We have discussed many of the benefits of this proposal previously in this Release, and therefore, we will focus more on the proposal's costs in this section, and will refer back to previous discussions of our proposal's anticipated benefits when appropriate.

443 The Commission staff's review is based in part on information obtained from Lipper's LANA Database.

based on these interviews, reviews, and examinations.

B. Impact of the Proposal

We have designed our proposal to minimize the cost impact on funds, intermediaries, and service providers while maximizing the investor protection and other benefits. As further discussed below, the staff anticipates that funds representing approximately 93% of all assets under management will incur minor or no expenses in complying with our proposal. This section contains some basic estimates about the size of the fund marketplace and its use of 12b-1 fees, and a general outline of what we believe our proposal's impact will be on certain market segments. Much of the information described in this section is included in two tables at the end of this section. The information is based on an analysis of data received on Form N-SAR and other filings and a review of a Lipper database.

The staff estimates that as of the end of 2009, there were approximately 9427 funds (consisting of 8611 traditional mutual funds and 816 ETFs) sponsored by 682 investment advisers.[444] Approximately 7367 of these funds have adopted a 12b-1 plan for one or more of their share classes.[445] Assets managed by all funds, as of the end of 2009, totaled approximately $12.2 trillion.[446]

The number of sponsors is roughly equivalent to the number of "fund families," which

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444 Like mutual funds, most ETFs are registered open-end management investment companies (a small number of ETFs are UITs). However, ETFs are counted separately from mutual funds in ICI statistics. The number of funds above reflects each separate series of a fund (many funds consist of more than one series or portfolio). Costs incurred in complying with the proposal may often be incurred at the fund "complex" or "family" level, and not at the series or class level, and, when appropriate, the staff has based its estimates on the number of sponsors or families affected rather than the number of series or classes.

445 A fund may have a 12b-1 plan, but not charge 12b-1 fees on one or more particular share classes of the fund.

446 This figure is based on staff examination of industry data, and includes traditional mutual funds, funds of funds, ETFs, and funds underlying insurance company separate accounts.

are groups of funds that share the same investment adviser or principal underwriter and hold themselves out to investors as related companies. Therefore, on average, each fund family has approximately 14 funds.[447] Of the 682 fund families, the staff estimates that approximately 379 (or 56%) have at least one fund in the family that currently has a 12b-1 plan. These fund families may be affected in some way by our proposal. The staff estimates that 172 of these 379 fund families (or 45%) only have funds that charge no more than 25 basis points in 12b-1 fees, and the remaining 207 (or 55%) have at least *one* fund that charges 12b-1 fees in excess of 25 basis points. The 207 fund families that have at least one fund that charges 12b-1 fees in excess of 25 basis points average 37 funds per fund family, a significantly higher average number of funds per family than the typical fund family.[448] As discussed previously, and in more detail below, we anticipate that funds that charge 25 basis points or less in 12b-1 fees would incur minimal costs under our proposal, while those that charge more than 25 basis points may be more significantly affected by our proposal.

The staff estimates that, as of the end of 2009, there were approximately 26,788 fund share classes. On average, the staff estimates that each mutual fund has approximately 3 share classes.[449] However, some funds only have one share class (including many no-load funds),

[447] This is based on the following calculation: (9427 funds ÷ 682 advisers = 14 funds per adviser). This number can and does vary widely, with some advisers managing only a single fund, and others managing hundreds of funds.

[448] The 207 advisers that advise at least one fund with a 12b-1 fee in excess of 25 bps advise a total of 7660 funds, for an average of 37 funds per family.

[449] This is based on the following calculation: (26,788 classes ÷ 8611 funds = 3 classes per fund). The staff excludes ETFs from this calculation because most ETFs offer only one class of shares, and therefore have reduced both the total fund and class number by the number of ETFs in this calculation. An ETF that is offered as a share class in a fund would be included in this estimate of average share classes per fund.

while others may have ten or more classes to support a variety of distribution arrangements.[450] Generally, funds that charge 12b-1 fees tend to have more share classes, because they offer multiple methods of paying for distribution (*e.g.*, at the time of purchase, at the time of redemption, or over time through the 12b-1 fee charged on fund assets) for investors with different needs and goals.[451] Thus, for purposes of estimating costs per fund in this analysis, the staff will assume that a typical fund that charges 12b-1 fees would have 4 classes: an A, B, and C share class, as well as an institutional or retirement share class.[452]

Of the 26,788 existing fund share classes, 12,646 (or 47% of all classes) do not charge a 12b-1 fee. These classes hold approximately \$7.3 trillion in assets.[453] The remaining 14,142 classes (or 53% of all classes) that do charge a 12b-1 fee hold approximately \$4.9 trillion in assets. The staff believes that 47% of fund classes (those that do not charge 12b-1 fees) are unlikely to incur any costs as a result of our rule proposal.[454] Thus, the staff believes that funds managing approximately \$7.3 trillion in assets, representing 60% of all assets under management, would not have to change their operations or disclosures as a result of our

[450] *See, e.g.*, Prospectus for The Growth Fund of America (Nov 1, 2009) (http://www.americanfunds.com/pdf/mfgepr-905_gfap.pdf).

[451] Not all funds that charge 12b-1 fees offer multiple retail classes. For example, the Legg Mason Funds only offer a single retail class of shares for their funds, a C share equivalent that charges 12b-1 fees without a front-end load. *See, e.g.*, Prospectus for Legg Mason American Leading Companies Value Trust (Aug 1, 2009), (http://prospectus-express.newriver.com/get_template.asp?clientid=legg&fundid=52465Q101&level=4&doctype=pros).

[452] *See supra* note 84. We do not expect that institutional classes would be affected by our proposal because funds do not typically charges 12b-1 fees on these classes.

[453] This figure is based on a staff examination of industry data and includes mutual funds, funds of funds, ETFs, and funds underlying insurance company separate accounts.

[454] If our proposal is adopted, we do not expect that fund classes that do not currently charge 12b-1 fees would begin charging asset-based distribution fees, because the fund would have already established a distribution structure and in light of the necessity of obtaining shareholder approval to institute such a fee.

proposal.[455]

A total of 6482 share classes (or 46% of classes that charge 12b-1 fees) charge a 12b-1 fee of 25 basis points or less. As discussed further below, although our proposal would affect these classes, we anticipate that the funds with these classes are likely to incur minimal costs associated with complying with our proposal. As a result, the staff anticipates that of all 26,788 fund share classes, 19,128 (which hold $11.3 trillion in assets, representing approximately 93% of all assets under management) would incur only minor, if any, costs if our rule proposals are adopted.[456]

Approximately 7660 (or 54%) of the share classes that have 12b-1 fees charge 12b-1 fees of greater than 25 basis points. All of these classes would be affected in some way by our rule proposals. These share classes hold approximately $855 billion in assets, or 17% of the assets managed by classes that charge 12b-1 fees, and 7% of all assets under management.

- We request comment on these estimates.

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455 This figure is based on the following calculation: ($7.3 trillion (assets not subject to a 12b-1 fee) ÷ $12.2 trillion (total assets under management) = 60% of assets under management not subject to a 12b-1 fee).

456 As discussed further below, we recognize that the cost impact of our proposal would not be distributed evenly across all funds, but rather that certain funds and fund families are likely to bear a greater share of the expenses that may result due to the nature of their distribution and operational models.

Table 1: 12b-1 Fees – Class Data

	Fund Classes	% of Total Classes
Classes without 12b-1 Fees	12,646	47%
Classes with 12b-1 Fees	14,142	53%
• **12b-1 Fees < or = 25 BPs**	6482	24%
• **12b-1 Fees > 25BPs**	7660	29%
Totals	26,788	100%

Table 2: 12b-1 Fees – Asset Data

	Assets (in billions)	% of All Fund Assets
Classes without 12b-1 Fees	$7289	60%
Classes with 12b-1 Fees	$4861	40%
• **12b-1 Fees < or = 25 BPs**	$4006	33%
• **12b-1 Fees > 25BPs**	$855	7%
Totals	$12,150	100%

C. Marketing and Service Fee

Proposed rule 12b-2 would allow funds to deduct from fund assets a marketing and service fee of up to the maximum rate of the service fee permitted under NASD Conduct Rule 2830 (currently 0.25% or 25 basis points of net fund assets annually).[457] The proposed 25 basis point marketing and service fee could be used for any legitimate distribution related activity including, but not limited to, the continuing shareholder account services encompassed by the

[457] Proposed rule 12b-2(b); NASD Conduct Rule 2830(d)(5).

NASD service fee.

1. Benefits

We anticipate that proposed rule 12b-2 would benefit investors by permitting funds to continue to pay for: (i) follow-up services provided to investors by brokers and other intermediaries after the sale has been made; and (ii) a fund's participation in distribution channels that offer investors a convenient way of buying shares, such as fund supermarkets[458] and retirement plans.[459]

We anticipate that our proposal would also benefit funds and their directors, and ultimately fund shareholders, by eliminating the procedural requirements of rule 12b-1. Under proposed rule 12b-2, boards of directors of funds that deduct a marketing and service fee would not be required to adopt a 12b-1 plan or annually approve it. As a result, funds and their advisers would no longer incur many of the costs of creating a 12b-1 plan, preparing quarterly and fiscal year reports of plan expenditures, or preparing materials that support the specific findings that fund boards are required to make annually in order to approve a 12b-1 plan, as discussed in more detail in Section I of this analysis.

As discussed above, fund boards would have discretion to use fund assets to finance distribution activities within the limits of the rule and their fiduciary obligations to the fund and fund shareholders. Therefore, we anticipate that funds would still incur some costs stemming from director review of arrangements paid for through the marketing and service fee. Our understanding is that, in general, funds pay their directors on an annual or per meeting basis, and

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458 *See supra* Section III.C.

459 Because these payments represent an integral part of many funds' distribution strategies, we believe that significantly restricting the ability of funds to continue to pay for these ongoing services through fund assets would likely disrupt existing distribution systems, impose significant costs on funds and intermediaries, and may have other unintended consequences that could adversely affect funds and fund shareholders.

we do not expect that the directors will reduce the frequency of their meetings as a result of the proposed marketing and service fee. Based on this assumption, we estimate that funds that currently charge a 12b-1 fee of 25 basis points or less will likely *not* realize significant cost savings as a benefit deriving from our proposal. However, the directors of funds that impose a marketing and service fee under proposed rule 12b-2 might spend less time on reviews and plan approvals, and instead be able to focus more of their time on other pressing concerns related to the fund's operations.[460]

2. *Costs*

We anticipate that funds that currently charge a 12b-1 fee of 25 basis points or less would not change the amount that they currently charge under proposed rule 12b-2. The proposed maximum amount of the marketing and service fee would be the same as the current NASD limit on service fees, and would also be the same as the current NASD limit on the amount of asset-based distribution fees that may be charged by funds describing themselves as "no-load." Thus, we expect that funds that currently use 12b-1 fees for these purposes would continue to charge the same level of fees. Because under the proposal, funds that currently charge 12b-1 fees of 25 basis points or less could charge marketing and service fees of the same or smaller amount without holding a shareholder vote, we expect that funds that currently charge 12b-1 fees of 25 basis points or less would incur only the costs of updating their disclosure documents as a result of our proposed rulemaking.[461]

As discussed above, we do not anticipate that funds that currently charge 25 basis points or less in 12b-1 fees would have to implement any significant systems changes or incur other

[460] We discuss the cost savings that might result from the proposed rescission of rule 12b-1 and its attendant director duties in Section V.I of this Release, *infra*.

[461] We estimate the costs of such disclosure changes in Section V.G of this Release, *infra*.

additional operational costs in order to impose a marketing and service fee under proposed rule 12b-2 because there should be no significant impact on operational expenses due to a transition from a 12b-1 fee of that level to a marketing and service fee. Nevertheless, directors and legal counsel to these funds and their advisers may require some time and training to review and understand the permissible uses and limits of marketing and service fees, compared to current practices. Commission staff estimates that for each fund family with one or more funds that charge a 12b-1 fee of 25 basis points or less, inside fund counsel would spend[462] approximately 20 hours[463] to review and understand the proposal and the board of directors would spend approximately 3 hours[464] to review and understand their responsibilities under the proposal. Because inside counsel and directors are typically not paid on an hourly basis, and the staff does not expect that funds would hire additional personnel or increase the frequency of meetings as a result of this proposal, the staff does not anticipate that this process would have any specific dollar costs for funds or advisers. However, we recognize that this represents time that directors and counsel would otherwise have spent on other fund business.

Based on these estimates, other than the costs of revising their disclosure documents

[462] Throughout this analysis we will estimate the cost of the time spent by internal personnel in complying with the proposal, because the time spent represents time that would otherwise be available for other activities of the fund (or relevant entity). Although these costs may be an economic cost of the proposal, it would not result in new monetary costs for funds, and would not result in the hiring of more staff by advisers or funds.

[463] The staff estimates that the internal time cost equivalent for time spent by internal counsel is $316 per hour, for a total cost per fund family of $6320 (20 hours x 316 per hour =$6230). This estimate of $316 per hour, as well as all other internal time cost estimates made in this analysis (unless otherwise noted) is derived from SIFMA's *Management & Professional Earnings in the Securities Industry 2009*, 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 or from SIFMA's *Office Salaries in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

[464] The staff estimates that the internal time cost equivalent for time spent by the boards of directors as a whole is $4500 per hour, for a total cost per fund family of $13,500 (3 hours x $4500 per hour = $13,500). The staff has estimated the average cost of board of director time as $4500 per hour for the board as a whole, based on information received from funds, intermediaries, and their counsel.

which we analyze later in the section on the disclosure amendments, the staff expects that the 6482 fund classes that currently charge 12b-1 fees of 25 basis points or less would incur no new costs in complying with proposed rule 12b-2. The assets under management of these classes represent approximately 82% of the total assets under management that are currently subject to 12b-1 fees.

We request comment on these estimates and assumptions regarding the costs of compliance with our proposal for funds that currently charge 12b-1 fees of 25 basis points or less.

- Is the staff correct in estimating that, other than costs to amend disclosure documents, these funds would incur no new dollar costs in complying with this part of our proposal? Is the estimate regarding time spent by inside counsel and directors reasonable? Would funds hire additional personnel, or otherwise incur additional or different costs or benefits than what we have estimated here?

D. Ongoing Sales Charge: Funds

The proposed amendments to rule 6c-10 would permit funds to deduct asset-based distribution fees in excess of the marketing and service fee in the form of an ongoing sales charge.[465] Proposed rule 6c-10(b) would limit ongoing sales charges to an amount that does not exceed the amount of the highest front-end load that the investor would have paid if he or she had invested in another class of shares in the same fund. Funds could also comply with the proposed rule amendments by deducting the ongoing sales charge only until the cumulative rates imposed on each share purchase matches the maximum front-end load, or in some

[465] For a complete discussion of the proposed ongoing sales charge, *see* Section III.D, *supra*. All funds that charge an ongoing sales charge would also incur the costs of implementing a marketing and service fee pursuant to proposed rule 12b-2 as well, as discussed in Section C above.

circumstances, the maximum sales charge limit set forth in NASD Conduct Rule 2830(d)(2)(A) (currently 6.25% of the amount invested). In effect, the proposal would treat asset-based distribution fees in excess of the marketing and service fee as a type of deferred sales load.

1. Benefits

We believe that the ongoing sales charge proposal would create a number of benefits, many of which are discussed above.[466] The proposed amendment would limit the cumulative ongoing sales charges that may be imposed on a purchase of fund shares to a set "reference load" (generally the highest front-end load charged on the fund's class A shares). As a result, investors would have the benefit of knowing, at the time of their purchase, either the maximum amount that they would pay for distribution, or the maximum length of time ongoing sales charges would be deducted. As a result, long-term shareholders would be protected from paying disproportionate amounts of sales charges in certain share classes, as is currently possible under rule 12b-1.[467] Finally, the ongoing sales charge would also be clearly identified and described in the fund prospectus and fee table, which should increase transparency and improve investor understanding of fees.

We believe that the ongoing sales charge proposal would also result in benefits for funds and fund directors. Under our proposal, funds would not have to adopt a "plan" in order to impose an ongoing sales charge, and fund directors would not be required to undertake time-consuming formal reviews and approvals of 12b-1 plans. Instead, funds and their boards would consider ongoing sales charges as integral parts of a fund's sales load structure and would review them under the same procedures under which boards currently review and approve the

466 *See supra* Section III.M.

467 *See, e.g.,* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007).

fund's underwriting contract. Boards could benefit from this to the extent it permits them to focus more on the fund's distribution system as a whole.

As a result of our proposal, funds may eventually incur lower compliance costs in tracking the sales charge limits established by NASD Conduct Rule 2830. As discussed previously, NASD Conduct Rule 2830(d)(2) imposes a complex, fund-level cap on the aggregate amount of sales charges, including asset-based sales charges, that may be imposed by funds sold by broker-dealer members. The investor-level cap on ongoing sales charges created by our proposal would provide an alternative means of ensuring that the NASD sales charge rule's maximum sales charge limits are not circumvented through the use of asset-based sales charges. If our proposal is adopted, FINRA may consider amending (or interpreting), this provision to eliminate the need for funds to track aggregate sales charges at the fund level.[468]

If FINRA were to amend (or interpret) this provision of Rule 2830, it could reduce compliance costs for these funds.[469] The staff estimates that funds currently spend $2000 in costs and 5 hours of internal staff time tracking these caps annually for each class that charges a 12b-1 fee in excess of 25 basis points. The costs are for computer and software resources, outside accountants, and other compliance costs. The 5 hours of internal time spent by these funds include 4 hours of time spent by accountants (at a cost of $153 per hour) and 1 hour spent by an assistant compliance director (at a cost of $326 per hour), for a total internal time cost equivalent of $938 per fund class.[470] As discussed above, approximately 7660 classes charge a 12b-1 fee in excess of 25 basis points, and we estimate that approximately 50% of these (or 3830

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468 *See* note 74 *supra (*discussing how rule 2830 provides a "minimum standard," and does not prevent a fund from developing a better method of tracking the loads paid by shareholders and ensuring that they do not overpay).

469 Funds that continue to have shares in classes with grandfathered 12b-1 fees pursuant to proposed rule 12b-2(d) would continue to incur these costs, however, during the grandfathering period.

470 This estimate is based on the following calculations: ($153 x 4 hours = $612; $612 + $326 =$938).

classes) may no longer need to incur these expenses. Therefore, the staff estimates a potential total annual cost savings of $7,660,000 and a time savings of 19,150 hours (representing an internal time cost equivalent of $3,592,540)[471] for this portion of the proposal for all funds.

- We request comment on these estimates and assumptions.

We considered several alternative methods of achieving the goals of this rulemaking, including potentially requiring individual shareholder level accounting of asset-based distribution fees, and prohibiting the deduction of asset-based distribution fees entirely. Although these alternatives might result in some of the benefits of the ongoing sales charge proposal, we expect they would come at a significant cost. Our proposal for an ongoing sales charge instead is designed to provide many of these benefits to investors, without significantly disrupting current distribution models or requiring most funds and intermediaries to develop costly new operating systems.

2. *Costs*

If adopted, the limitations on ongoing sales charges contained in proposed rule 6c-10(b) would require funds that currently charge 12b-1 fees in excess of 25 basis points to amend their share classes and/or alter their operations in one of several ways. First, some funds may choose to amend their share classes so that they conform to the new requirements (*e.g.*, by reducing their fees to a level that would not implicate the ongoing sales charge limitations). Second, other funds might restructure their expenses and separate non-distribution related expenses from their asset-based distribution fees in order to keep total fees from exceeding 25 basis points. Third, some funds might keep their present share classes, but issue new shares that comply with the proposed rule amendments after a certain date (*i.e.*, "old" and "new" shares would be mixed in

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[471] This is based on the following calculation: ($938 × 3830 classes = $3,592,540 time savings value; 5 hours × 3830 classes = 19,150; $2,000 × 3830 classes = $7,660,000 cost savings).

the same class). Fourth, other funds might create new share classes on or before the compliance date that meet the proposal's requirements. The chosen method of complying with the new requirements would likely be driven by the fund's business model and the cost-effectiveness of each option given the fund's particular circumstances. In general, the staff assumes that either funds or their advisers or other service providers would bear the costs of implementing these changes.[472] The costs of each of these potential compliance options are discussed below.

a. Fee Reductions

Funds with classes that currently charge 12b-1 fees of more than 25 basis points might determine that it would be cost effective to reduce their asset-based distribution fees to the 25 basis point cap of the marketing and service fee. Funds could accomplish this by either reducing their distribution expenses or shifting a portion of the costs to their adviser or another party. These funds could continue offering their existing share classes without having to provide for a conversion period under proposed rule 6c-10(b).

We anticipate that, out of the funds that charge a 12b-1 fee of more than 25 basis points, only those funds that charge up to 30 basis points would likely reduce their asset-based distribution fee to 25 basis points or less. We expect that funds that charge more than 30 basis points would be unlikely to find the reduction to 25 basis points or less to be the most cost effective means of complying with our proposal, and therefore would be unlikely to pursue this alternative. Commission staff estimates that there are approximately 471 fund classes that

[472] Fund families are organized in many ways, with some having affiliated transfer agents, underwriters and other service providers, and others contracting these services out to unaffiliated third parties. The staff understands that some contracts obligate the fund to reimburse the transfer agent for system costs related to regulatory changes, while other contracts require the transfer agent to bear these expenses. Because of the variability in these contract terms, throughout this analysis, when the staff estimates costs, the staff generally assumes that the estimated costs would be borne directly by the affiliated service providers and the fund family, or indirectly through increased expenses charged by unaffiliated service providers. Except in the case of retirement plan record keepers, who may face unique issues in responding to this proposal, the staff does not break these costs out separately.

charge 12b-1 fees of more than 25 up to and including 30 basis points (representing $143 billion in assets), and that 40% of these classes (188) may reduce their fees to 25 basis points or less in response to our proposal. The average class that charges 12b-1 fees in this range has approximately $304 million in assets. If a class with $304 million in assets that charged 30 basis points reduced its 12b-1 fees to 25 basis points, investors in that class would see their 12b-1 fees reduced by approximately $152,000 annually. If all of the classes that chose to reduce their fees charged the full 30 basis points, the maximum fee reduction would be approximately $28,576,000 a year.[473]

These reductions in fees could be viewed as a cost to these funds or their advisers. Nonetheless, investors in the funds would experience a corresponding and offsetting dollar-for-dollar benefit due to lower expenses. In any event, a fund likely would only elect this alternative if it determined that the reduction would be cost effective. We request comment as to the likelihood that funds would respond to our proposal with fee reductions.

- Are we correct in assuming that only funds that charge between 25 and 30 basis points are likely to reduce their fees? How many funds would choose this option? What kind of costs would they or their affiliates bear to reduce their current 12b-1 fee, if any?

b. Fee Restructuring

Many funds currently pay for expenses that are not distribution related with 12b-1 fees (such as administrative, sub-transfer agency, or other fees). As a result, we expect that some funds with classes that impose 12b-1 fees of more than 25 basis points, up to and including 50 basis points (*e.g.,* some A and R share classes), might instead be able to treat the amount greater

[473] This estimate is based on the following calculation: ($152,000 x 188 classes = $28,576,000).

than 25 basis points as a fund operating expense. These funds would have to carefully examine their 12b-1 fees and identify which, if any, expenses could be properly classified as non-distribution expenses. If non-distribution expenses paid through 12b-1 plans are significant enough, these funds might be able to reduce their asset-based distribution fees to the 25 basis point cap and avoid being subject to the ongoing sales charge limits and conversion periods in proposed rule 6c-10(b).

The staff estimates that there are approximately 2168 fund classes that charge 12b-1 fees of more than 25 up to and including 50 basis points. The staff previously estimated that approximately 188 of these classes may respond by reducing their fees, leaving a total of 1980 classes that fall into this category. Of those classes, the staff estimates that approximately 50% (or 990 classes) may be able, and find it cost effective, to re-characterize a portion of their current 12b-1 fee.

We expect that funds that choose this course of action would incur the costs of: (i) conducting an internal review of the fees and expenses charged by the affected share classes; (ii) amending fund prospectuses and disclosure documents to reflect the fee re-structuring (as discussed in greater detail below); and (iii) modifying operational and accounting systems to reflect the restructured fees. The staff estimates that it would take approximately 20 hours of inside counsel time (at an internal time cost-equivalent of $316 per hour), and 1 hour of time for each board as a whole (at an internal time cost equivalent of $4500 per hour), for a total internal time cost equivalent of $10,820 to complete these tasks for each class.[474] The staff estimates that funds may incur an additional $5,000 in outside counsel expenses associated with the internal

474 This is based on the following calculations: ($316 × 20 = $6320); ($6320 + $4500 = $10,820).

review and disclosure changes.[475]

Therefore, we estimate that it would cost the 990 fund classes that might perform this internal review and re-assessment of expenses approximately $4,950,000 in outside expenses and $10,711,800 in internal time cost equivalent to comply with our proposal.[476] We assume that the other 990 fund classes that charge between 25 and 50 basis points in 12b-1 fees, but do not re-assess these fees or otherwise reduce their fees to 25 basis points or less, would impose an ongoing sales charge in compliance with proposed rule 6c-10(b). Their costs are discussed below.

We request comment on these estimates and assumptions.

- Is the staff's estimate of $5,000 per fund class for outside counsel expenses, 20 hours of inside counsel time, and 1 hour of board time reasonable for the internal review and disclosure amendment process? If not, what would be a better estimate? Are there other costs that might be associated with such a review?

c. Ongoing Sales Charge: Conversion and Modified Share Classes

Under our proposed amendments to rule 6c-10, funds with asset-based distribution fees in excess of 25 basis points (*i.e.* with ongoing sales charges) that issue new shares after the compliance date, must have, or create, a share class that does *not* impose an ongoing sales charge (such as a typical class A) into which shares with the ongoing sales charge would convert after a set period of time (a "target class").[477] We anticipate that there would be two primary sets of costs that these fund families may incur related to our proposed amendments to rule 6c-10: (i)

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475 Any operational and accounting system costs would be likely made at the fund family level, and are included in the staff's estimated costs for fund families complying with the ongoing sales charge proposal, as discussed below.

476 This estimate is based on the following calculations: ($5000 per class × 990 classes = $4,950,000 total expenses); ($10,820 per class × 990 classes = $10,711,800 total internal time cost equivalent).

477 *See supra* Section III.D for a further discussion of the operation of the proposed rule.

updating or creating a conversion system, and (ii) amending or creating new share classes. Both sets of costs would include expenses related to building or enhancing systems and back office technology and operations.

(i) Conversion System

As a preliminary matter, the staff estimates that approximately 90% (or 186) of the 207 fund families[478] that may be affected by our proposed amendments to rule 6c-10 have at least one fund with a class of B shares and, as a result, have a conversion system in place that they could use to convert shares with ongoing sales charges. The staff estimates that it may cost a fund family $100,000 in one time initial costs, and $50,000 annually, to modify an existing B share conversion system to manage the conversions of funds with ongoing sales charges. These costs would include: (i) computer hardware needed to store an increased volume of transaction activity; (ii) computer software to expand and update the systems' ability to track share lots and convert the shares based on the new aging schedules; and (iii) expanding back office and accounting operations and hiring and training additional back office personnel.

The other 10% or 21 fund families that do not have conversion systems may incur additional costs to create a conversion system, or contract for one through an external service provider. The staff estimates that it would cost a fund family (or its affiliated transfer agent) approximately $250,000 in initial costs and $100,000 in annual costs to purchase or create a conversion system, integrate existing computers, software, and networks, train personnel, and update records. The staff estimates it would cost approximately the same amount to outsource

478 As we have discussed previously, a number of funds may avoid these costs by reducing their asset-based distribution fees or by re-characterizing expenses. Although some funds in a family may be able to avoid such costs, it may be that only a few funds in the family could do so, and therefore the fund family as a whole would still incur these costs of complying with this part of our proposal. The staff has therefore chosen to be conservative and include all fund families that might be affected by the ongoing sales charge proposal in the cost estimates below.

this type of system to an outside vendor. Because a fund family's class structure generally is intimately tied to its conversion system, as discussed below, we expect that the decision to amend or create new share classes would be made in coordination with any changes to the conversion system.

(ii) Operational Changes and Modified Share Classes

Next, we describe four potential routes that we believe fund families could use to come into compliance with our proposed amendments to rule 6c-10. In addition, we describe the staff's estimates of the number of fund families that may use each route and the potential costs. These routes include: (1) retaining existing share class structures and conversion systems; (2) updating the fund family's existing conversion system and amending the class structure; (3) updating the fund family's existing conversion system, amending the class structure, and creating new share classes; and (4) creating/purchasing a new conversion system, amending the class structure, and creating new share classes. Because these routes are general paths to compliance with our proposed amendments to rule 6c-10, we expect that the experience of each fund family would likely vary significantly from the average costs outlined below. In addition, some fund families may need to "mix and match" parts of these outlined routes to meet the particular needs of each fund within the fund family. However, we would expect that affected fund families would generally comply with the proposed amendments in one of the ways described above.

Funds would also have a variety of choices in managing shares with 12b-1 fees that have been grandfathered pursuant to proposed rule 12b-2(d). Some fund families may choose to retain grandfathered 12b-1 share classes for the period allowed, and *amend* those classes so that future share purchases comply with the proposed amendment to rule 6c-10 (essentially mixing shares with differing conversion dates in the same class), and then converting or exchanging the grandfathered shares into the amended classes after five years. Other fund families may decide not to grandfather 12b-1 shares and instead amend their existing classes to fully comply with the proposed amendments to rule 6c-10 for both new and existing shareholders (effectively applying the requirements of the proposal to existing shares and not taking advantage of the grandfathering provisions of proposed rule 12b-2(d)). Finally, some funds may choose to manage grandfathered shares by leaving those assets in existing classes for the period allowed, and *creating* new share classes for all future share purchases, and then converting or exchanging the grandfathered shares into the new classes after five years. In any event, we anticipate that fund families would choose the method that is most cost-effective and is in the best interest of the fund family and its shareholders. The method of managing share classes with grandfathered 12b-1 fees selected by the fund family is likely to influence the route that the fund family would select in complying with our proposed amendments to rule 6c-10(b), and we have included the costs of managing share classes with grandfathered fees in the staff's estimates below.[479]

Route 1: Retain Existing Share Class Structure and Conversion Systems

A fund family that sells funds with an existing class structure that already generally complies with our proposed amendments to rule 6c-10 might only need to make minor changes to its operations in response to our proposal. A fund family that does not sell C shares, sells B shares that convert at a time that is consistent with proposed rule 6c-10(b), and has a target class for converted shares (*i.e.*, a class that deducts 25 basis points or less in asset-based distribution

[479] Funds that amend or update existing share classes as a result of our proposal would provide notification to their existing shareholders. If the proposal is adopted, we anticipate providing a transition period of at least 18 months, which should allow most funds to provide this notification in their next regularly scheduled prospectus update, or in an annual or semi-annual report. In some cases, due to timing constraints, a fund may determine that it needs to "sticker" its registration statement and inform its shareholders of the share class changes in a separate and unscheduled communication. These funds would incur additional costs.

fees), would be included in this category.[480] The costs and time expended by such a fund family to comply with the proposed amendments to rule 6c-10 would include: reviewing the requirements of the rule (if adopted); updating fund prospectuses, SAIs, and shareholder reports to reflect the changed terminology and function of the two new types of asset-based distribution fees; reviewing and making any necessary updates to compliance policies and procedures; hiring outside counsel to perform these reviews and updates; and providing training to relevant internal personnel (*i.e.*, staff from the fund, adviser, or underwriter).

The staff estimates that approximately 15% (or 28) of the 186 fund families that may be affected would be able to comply with the proposal by making these minor changes to their operations. The staff estimates that fund families that would make these operational changes would incur approximately $20,000 in one-time costs, and 100 hours of time expended by internal personnel to implement these changes for the entire fund family. The staff estimates that the 100 hours spent by internal personnel would break down as follows: 50 hours spent by accountants and other back office personnel at $153 per hour; 30 hours spent by programmers and other IT personnel at $190 per hour; 18 hours spent by internal counsel at $316 per hour; and 2 hours spent by the board of directors at $4500 per hour, for a total internal time cost equivalent of $28,038.[481] The staff therefore estimates that the total costs for all affected fund families that use this route would be $560,000 in one-time costs and 2800 hours of internal personnel time

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480 Such a fund would be unlikely to incur any costs relating to managing shares with grandfathered 12b-1 fees because its existing class structure would already be in compliance with our proposed amendments and, thus, it would not need to maintain separate classes for shares with grandfathered 12b-1 fees.

481 These figures are based on the following calculations: (50 hours × $153 = $7650); (30 hours × $190 = $5700); (18 hours × $316 = $5688); (2 hours × $4500 = $9000); ($7650 + $5700 + $5688 + $9000 = $28,038 total internal time cost equivalent).

expended at a total internal time cost equivalent of \$785,064.[482]

- We request comment on these estimates and assumptions.

Route 2: Update Conversion System and Make Amendments to Class Structure

Alternatively, funds might need to make amendments to their existing share classes to comply with our proposal.[483] These funds may need to change the conversion period of their class B shares, institute a conversion period for class C shares, or make other changes to their class structure. However, the staff assumes that fund families that choose this route would not need to create new share classes, because they would already have a target class for conversions that meets the requirements of proposed rule 6c-10(b) (*e.g.*, an existing share class with 12b-1 fees of 25 basis points or less). The staff expects that these fund families would not choose to create new share classes for purchases made after the compliance date of the proposal (if adopted), but would instead amend their existing classes.[484] These fund families would also have to update their conversion systems, at a previously estimated one-time cost of \$100,000 and \$50,000 annually. The staff estimates that approximately 50% (or 93) of the 186 fund families that may be affected would need to amend their existing share classes as a result of our proposal. The staff estimates that, on average, each fund that amends its share classes would need to amend an average of two share classes. The staff estimates that it would typically cost

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482 These figures are based on the following calculations: (\$20,000 costs × 28 fund families = \$560,000); (100 hours × 28 fund families = 2800); (\$28,038 × 28 fund families = \$785,064).

483 Pursuant to rule 18f-3, fund share classes are required to be organized according to a written plan that is approved by the fund's directors, and thus this plan must be amended when changes are made to a share class.

484 Instead, they would either amend existing classes to mix grandfathered 12b-1 fee shares with new purchases with differing conversion dates, or would not grandfather existing 12b-1 fees. In either case, these funds would amend existing share classes, but would not create new ones. The costs for funds that choose to create new share classes as a means of managing share classes with grandfathered 12b-1 fees or in response to our proposed amendments to rule 6c-10 are described in our discussion of route 3, below.

approximately $10,000 and 25 hours of internal personnel time to amend a share class to meet the requirements of our proposed amendments to rule 6c-10.

However, the staff expects that most fund families would amend all of the relevant share classes at the same time as part of a coordinated plan for compliance with the proposed rules, and therefore should be able to achieve significant economies of scale. Much of the work involved in amending one share class is similar to that involved in amending other classes, and if all amendments are undertaken at the same time, significant efficiencies and elimination of duplicative effort should result. The staff therefore estimates that a fund family with 35 funds (the average for fund families that have at least one fund with 12b-1 fees in excess of 25 basis points) would incur a total of $100,000 in outside expenses and 250 hours of internal personnel time expended. The time would represent approximately 140 hours spent by accountants and other back office personnel at a rate of $153 per hour, 100 hours spent by inside counsel at a rate of $316 per hour, and 10 hours spent by the board of directors as a whole, at a rate of $4500 per hour, for a total internal time cost equivalent of $98,020.[485]

These costs and time expenditures would include internal staffing and outside counsel review to establish the amended terms of the class, creating and/or amending relevant disclosure documents, amending the written plan setting forth the terms of the funds' class structure, holding a director vote on the class plan if necessary, any training expenses, costs related to amending distribution or underwriting agreements, and any costs related to altering the terms of the class on the fund or its transfer agent's systems, the costs of exchanging or converting remaining grandfathered shares into appropriate share classes after the expiration of the grandfathering period, as well as the costs of updating the fund family's operations discussed

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[485] These figures are based on the following calculations: ($153 × 140 hours = $21,420); ($316 × 100 hours = $31,600); ($4500 × 10 hours = $45,000); ($21,420 + $31,600 + $45,000 = $98,020).

above.[486] The staff assumes that the costs of maintaining these amended share classes would be the same as the cost of maintaining current share classes, and therefore the staff estimates that funds that choose this option would incur no additional ongoing annual cost burden.

Therefore, the staff estimates that each fund family would incur $100,000 in costs and 250 hours in internal personnel time (at an internal time cost equivalent of $98,020) to amend their share classes, and an additional $100,000 in one-time costs and $50,000 in annual costs to update their conversion systems, for a total one-time cost of $200,000, annual costs of $50,000, and 250 hours of time expended for each of these fund families to comply with the ongoing sales charge portion of our proposal. Based on these estimates, the staff further estimates that all 93 potentially affected fund families that may choose this option would incur a total of $18,600,000 in one-time costs, $4,650,000 annually, and 23,250 hours in one-time internal personnel time expended at an internal time cost equivalent of $9,115,860.[487]

- We request comment on these estimates and assumptions.

Route 3: Update Conversion System, Make Significant Changes to Class Structure, and Create New Share Classes

Other fund families may need to create new share classes to comply with our proposed amendments to rule 6c-10. These fund families might need to create new share classes either because they do not have an appropriate target class for conversions (for example, if their class A shares deduct more than 25 basis points in asset-based distribution fees), or if they chose to maintain grandfathered 12b-1 assets in existing share classes and create new share classes for all

486 The costs of amending the fund family's operations, as discussed above under route 1, is included in this estimate.

487 These figures are based on the following calculations: ($200,000 one-time costs × 93 fund families = $18,600,000); ($50,000 annually × 93 fund families = $4,650,000); (250 hours × 93 fund families = 23,250 hours); ($98,020 × 93 fund families = $9,115,860).

future share purchases after the compliance date of the rule (if adopted).[488] In addition to creating new share classes, these fund families would also likely need to amend their existing share classes. These fund families would also need to update their conversion systems, at a previously estimated one-time cost of $100,000, and $50,000 annually.[489]

The staff estimates that the remaining 35% (or 65) of 186 potentially affected fund families with conversion systems would create new share classes in response to our proposed amendments to rule 6c-10. The staff estimates that it would cost each fund approximately $100,000 and 100 hours of internal personnel time to create a new share class.[490] These expenses would include internal staffing and outside counsel involvement to establish the terms of the new class, create and/or amend relevant disclosure documents, amend the written plan setting forth the terms of the funds' class structure, hold a director vote if necessary, any training expenses, the costs of amending distribution and underwriting agreements, the costs of exchanging or converting remaining grandfathered shares into appropriate share classes after the expiration of the grandfathering period, any costs related to implementing the new class on the fund's or transfer agent's systems, and any costs related to updating the fund's operations discussed above. The staff's estimate assumes that the costs of maintaining these new share

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488 For example, a fund might have a class A that deducts 35 basis points in asset-based distribution fees, class B shares that convert at a date later than the proposal would require, and class C shares that do not convert. This fund might need to create a new class A that deducts 25 basis points or less as a target class for conversions, and if the fund chose to maintain grandfathered assets in the existing A and C shares classes, might also create a new class A and C that meets the terms of the proposal. In addition, the fund may choose to amend the conversion requirements of the class B shares to comply with the requirements of the proposal for both new and existing shareholders ("mixing" conversion dates in the same class). This fund would be creating three new share classes and amending one other class.

489 *See supra* Section V.D.2.c.(i).

490 As discussed below, funds that choose this option would likely achieve significant cost savings and economies of scale by creating all new classes simultaneously. To be conservative, however, Commission staff has also estimated the costs of creating each class individually.

classes would be the same as the costs of maintaining current share classes, and the staff estimates that funds that choose this option would incur no additional ongoing annual cost burden related to the class structure changes. The staff estimates that, on average, each fund that creates new share classes would need to create two new share classes and amend one additional share class (at the same cost as amending share classes discussed above).

However, as discussed previously, the staff expects that most fund families would make all necessary changes to their distribution structure as part of a coordinated plan for compliance with the proposed rules, and therefore should be able to achieve significant economies of scale and costs savings over the costs of amending or creating a single share class. For example, often, a number of funds in a family share a single prospectus, which could be amended at a single time, and the class structure could be amended with a single director vote. In light of these expected economies of scale, the staff estimates that a typical fund family would incur $800,000 in costs and 500 hours in internal personnel time to create new share classes, and $50,000 in costs and 100 hours in internal personnel time expended to amend existing share classes, for a total of $850,000 in outside costs and 600 hours of internal personnel time expended. The internal personnel time expended would include approximately 200 hours spent by programmers and other back office IT staff at a rate of $190 per hour, 200 hours spent by accountants at a rate of $153 per hour, 190 hours spent by inside counsel at a rate of $316 per hour, and 10 hours spent by the board of directors as a whole at $4500 per hour, for a total internal time cost equivalent of $173,640.[491] Including $100,000 in one-time costs and $50,000 in annual costs to update their conversion systems, the total cost for each fund family would be $950,000 in one-

[491] These figures are based on the following calculations: ($190 × 200 hours = $38,000); ($153 × 200 hours = $30,600); ($316 × 190 hours = $60,040); ($4500 × 10 hours = $45,000); ($38,000 + $30,600 + $60,040 + $45,000 = $173,640).

time costs, \$50,000 in annual costs and 600 hours expended.

Based on these staff estimates, the 65 potentially affected fund families would incur a total of \$61,750,000 in one-time costs, \$3,250,000 in annual costs, and 39,000 hours in one-time internal personnel time expended (at an internal time cost equivalent of \$11,286,600) to comply with our proposal.[492]

- We request comment on these estimates and assumptions.

Route 4: Purchase New Conversion System, Make Significant Changes to Class Structure, and Create New Share Classes

Finally, if our proposed amendments to rule 6c-10 are adopted, some funds would have to purchase or create a conversion system. As previously discussed, the staff estimates that 10% or 21 fund families that may be affected by our proposed amendments to rule 6c-10 currently do not have a conversion system, either because they only sell a single class of shares, or if they sell multiple classes of shares, none of their share classes has a conversion feature. The staff has previously estimated that that it would cost approximately \$250,000 in initial costs and \$100,000 in annual costs to purchase or create a conversion system.

In addition to purchasing a new conversion system, these fund families would also need to create a new target class for converted shares and amend existing share classes to meet the requirements of our proposed amendments to rule 6c-10. For example, if a fund sold only class C shares that deducted asset-based distribution fees in excess of 25 basis points, the fund would need to create a new target class for converted shares. In addition, if the fund chose to maintain grandfathered 12b-1 assets in the existing class, the fund may need to create a second class of

[492] These figures are based on the following calculations: (\$950,000 one-time costs × 65 fund families = \$61,750,000); (\$50,000 annually × 65 fund families = \$3,250,000); (600 hours × 65 fund families = 39,000 hours); (\$173,640 × 65 fund families = \$11,286,600).

shares for future purchases. On the other hand, if the fund chose to dispense with grandfathering 12b-1 fees, it might amend the existing C class so that it complied with our proposed amendments to rule 6c-10 for both existing and new shareholders.

The staff has previously estimated that it may cost each fund approximately $100,000 and 100 hours of internal personnel time to create a new share class and $10,000 and 25 hours to amend a share class. The staff assumes that each affected fund that does not currently convert shares would have to create two new share classes and amend one additional share class to meet the requirements of the proposed amendments to rule 6c-10.

However, as discussed previously, the staff expects that most fund families would make all necessary changes to their distribution structure as part of a coordinated plan for compliance with the proposed rules, and therefore should be able to achieve significant economies of scale and costs savings over the costs of amending or creating a single share class. In light of these expected economies of scale, the staff estimates that each fund family would incur $800,000 in costs and 500 hours in internal personnel time to create new share classes, and $50,000 in costs and 100 hours in internal personnel time expended to amend existing share classes, for a total of $850,000 in outside costs and 600 hours of internal personnel time expended. The internal personnel time expended would include approximately 200 hours spent by programmers and other back office IT staff at a rate of $190 per hour, 200 hours spent by accountants at a rate of $153 per hour, 190 hours spent by inside counsel at a rate of $316 per hour, and 10 hours spent by the board of directors as a whole at $4500 per hour, for a total internal time cost equivalent of $173,640.[493] Including $250,000 in one-time costs and $100,000 in annual costs to purchase or

[493] These figures are based on the following calculations: ($190 × 200 hours = $38,000); ($153 × 200 hours = $30,600); ($316 × 190 hours = $60,040); ($4500 × 10 hours = $45,000); ($38,000 + $30,600 + $60,040 + $45,000 = $173,640).

build a conversion system, the total cost for each fund family would be $1,100,000 in one-time costs, $100,000 in annual costs and 600 hours expended.

Based on these staff estimates, the 21 potentially affected fund families would incur a total of $23,100,000 in one-time costs, $2,100,000 in annual costs, and 12,600 hours in one-time internal personnel time expended (at an internal time cost equivalent of $3,646,440) to comply with our proposal.[494]

- We request comment on these estimates and assumptions.

E. Ongoing Sales Charge: Investors

Investors currently appear to have difficulty understanding 12b-1 fees and the activities and services for which they are used.[495] Our proposal would differentiate between the two constituent parts of current 12b-1 fees (asset-based sales charges and service fees). It would allow funds to use a limited amount of assets as a marketing and service fee, and deduct any excess amounts over the marketing and service fee as an ongoing sales charge. The renamed fees would appear separately in an amended fee table in the prospectus under the headings "marketing and service fees" and "ongoing sales charge."

By more clearly identifying the two types of asset-based distribution fees, we expect that the proposal would make it easier for investors to understand when they are paying a sales charge. In addition, these proposed changes to the fee table and the revised narrative disclosure in the prospectus should also help investors better understand the services they are paying for through the marketing and service fee and the ongoing sales charge. This improved understanding should help investors more easily compare sales charges in alternative share

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494 These figures are based on the following calculations: ($1,100,000 one-time costs × 21 fund families = $23,100,000); ($100,000 annually × 21 fund families = $2,100,000); (600 hours × 21 fund families = 12,600 hours); ($173,640 × 21 fund families = $3,646,440).

495 *See supra* Section II.E.

classes and competing funds and, therefore, choose the sales charge option that best meets their investment needs. We anticipate that this would lead investors to choose lower priced offerings of funds or share classes that offer comparable services, which should lead to greater price competition among funds and lower sales charges.

Investors empowered with this information may invest differently. Although we cannot predict investor behavior, we assume that if offered lower prices for the same services, or provided with better information regarding the distribution services received, many investors would choose to move their investments to, or make new investments in, a fund or share class with lower asset-based distribution fees or loads. Conversely, investors may decide to avoid funds that charge high asset-based distribution fees if they believe that they would not get, or want, commensurate levels of service. We expect that investors who choose to shift invested assets would only move assets that are not subject to a CDSL, or on which they had not already paid a front-end load. Thus, we do not anticipate that investors would shift assets invested in class A or B shares if our proposal were adopted. In addition, our proposal would require that assets held for long periods of time in level load classes (for example, class C shares) eventually convert to classes that do not deduct an ongoing sales charge, which would result in a net movement of assets out of these level load classes into lower cost classes.

Commission staff estimates that approximately $686 billion in total net assets currently are invested in level load share classes, and that approximately $3.4 billion in 12b-1 fees are deducted from these assets fees annually, for an average 12b-1 fee as a percentage of total net assets in these classes of 50 basis points.[496] The staff further estimates that if our proposed rule

[496] We recognize that some portion of the 50 basis points may represent service fees and that an investor who shifts their assets from a level load fund class may still select a fund class that charges a service fee or a reduced ongoing sales charge. However, for purposes of this analysis, the result of the staff's

and disclosure amendments are adopted, improved investor understanding of distribution related charges would result in an aggregate total of between five and ten percent of assets currently invested in level load classes (for example, C shares) moving to share classes (within the same fund or in a different fund) that do not deduct an asset-based distribution fee. If *five percent* of the $686 billion in assets in these classes (or $34 billion) were moved to share classes without asset-based distribution fees, at an annual 12b-1 fee rate of 50 basis points, investors would save approximately $170 million annually.[497] If *ten percent* of the $686 billion in assets in these classes (or $68 billion) were moved to share classes without asset-based distribution fees, investors would save approximately $340 million annually.[498] Over a ten-year period, this would represent a potential savings of between $1.7 billion and $3.4 billion to investors in asset-based distribution fees that they would otherwise have paid, but would avoid because of better informed decision making.

If our proposal is adopted, we would provide a grandfathering provision for current 12b-1 share classes for a five-year period. However, at the end of that five-year period, all shares that are currently subject to a 12b-1 plan would need to be converted or exchanged into a class that does not deduct an ongoing sales charge and with a marketing and service fee that is no higher than the 12b-1 fee in effect in the previous fiscal year. This expiration of the grandfathering period would effectively time limit level load share classes as they exist today. All assets that remain in level load share classes after the expiration of the grandfathering period would need to be converted to a class that does not deduct an ongoing sales charge; effectively a class that

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estimates represent the total cumulative effect of all asset movement from level load funds to no-load or lower load funds.

497 This estimate is based on the following calculation: ($34,000,000,000 × 0.005 = $170,000,000).

498 This estimate is based on the following calculation: ($68,000,000,000 × 0.005 = $340,000,000).

charges 25 basis points or less in asset-based distribution fees. This conversion or exchange would benefit investors who remained in these level load classes at the end of the grandfathering period to the extent that the asset-based distribution fees on the share class they are converted into is lower than the current 12b-1 fee.

The staff estimated above that the average 12b-1 fee on level load share classes is 50 basis points. Because no ongoing sales charge could be charged on the converted or exchanged shares and the highest marketing and service fee allowed under the proposal is 25 basis points, the staff estimates that investors who remain in the grandfathered 12b-1 share class would save 25 basis points a year after the expiration of the grandfathering period. However, as discussed above, the staff estimates that some investors may move their existing level load assets to lower load classes as a result of this proposal, and further reductions in the assets of existing level load share classes may occur through redemptions or reduced investment. The staff estimates that at the expiration of the grandfathering period in five years, approximately 50% of the $686 billion (or $343 billion) in existing level load share class assets will remain. Upon the conversion or exchange of these assets into share classes that do not deduct an ongoing sales charge, the staff estimates that investors in these classes will save 25 basis points a year (the asset-based distribution fees charged in excess of the amount permitted as a marketing and service fee), or a total of $857,500,000 annually.[499]

In addition, if our proposal is adopted, we estimate that net new investments in level load fund classes would decline as investors choose share classes with no or lower sales charges, whether in the form of an asset-based distribution fee, front-end load or CDSL, and as a result of requirements in the proposal to eventually convert shares that charge an ongoing sales charge

[499] This estimate is based on the following calculation: ($343,000,000,000 × 0.0025 = $857,500,000).

into a class that does not deduct such a fee at a set time. The staff estimates net new investments in level load fund classes may decline between ten and twenty percent as a result of our proposal (with a commensurate increase in net new investments in no or low load funds). Based on a review of Lipper's LANA Database and data filed with the Commission, the staff estimates that approximately $52 billion in net new cash flowed to level load classes in 2009, with those level load classes charging an average asset-based distribution fee of approximately 50 basis points. Assuming that there would be similar net cash flow to these classes in future years, if *ten percent* of the net new cash flow to level load classes (or $5.2 billion) is invested in classes that do not charge asset-based distribution fees, Commission staff estimates that investors would save approximately $26 million annually.[500] If *twenty percent* of the net new cash flow to these classes (or $10.4 billion) is instead invested in classes that do not charge asset-based distribution fees, Commission staff estimates that investors would save approximately $52 million annually.[501] Over a ten-year period, this represents potential savings of between $260 million and $520 million for investors who might be better served in other classes with a more appropriate level of service for their needs or wants.

As discussed above, we expect that one result of our proposal would be a net shift by investors to lower load share classes. As part of this net shift, we would expect that some investors might determine that they need or want continuing high levels of service, and may choose to move their assets out of level load share classes and into fee-based or wrap fee accounts, which may have higher expenses than the level load share classes the investor had

[500] This estimate is based on the following calculation: ($5,200,000,000 × .005 = $26,000,000).

[501] This estimate is based on the following calculation: ($10,400,000,000 × .005 = $52,000,000).

previously owned.[502] These investors may pay higher expenses as a result of this choice, but would presumably also receive higher levels of service, and the ability to trade between funds in different fund families without paying additional loads. The proposal would provide investors with better information regarding the asset-based distribution fees they pay, which should enhance the ability of investors to select the type of account or method of paying distribution fees that is best for them, even if some investors choose to invest through more costly methods as a result.

There is some question as to whether a reduction in asset-based distribution fees paid by investors would be purely a benefit of the proposal resulting from markets that are more efficient and investors making better-informed investment choices, or whether it would represent a transfer of assets from investment managers or broker-dealers to investors. The goals of this rulemaking include providing better and more transparent information to investors regarding the asset-based distribution fees they pay, enabling investors to more efficiently allocate their investments and meet their investment goals, and promoting competitive markets. In light of these goals, we believe that any reduction in asset-based distribution fees paid by investors that is due to better-informed investment decisions made as a result of this proposal should be counted as a benefit.

- Do commenters agree that the estimated reductions in sales charges investors would pay are a benefit of this proposal? We further request comment on the estimates and assumptions we have made in this section regarding the benefits of our proposal to

[502] Other investors, however, would move their assets into lower cost funds, as discussed previously. Level-load share classes typically deduct 100 basis points or less in asset-based distribution fees annually. Fee-based or wrap accounts often charge higher fees (between 100 and 200 basis points annually) but the broker-dealers that offer wrap accounts also provide additional services and transaction options for their clients.

investors and the likelihood that a certain portion would invest in funds with lower sales charges. In particular, we request comment on the quantitative estimates the staff has made and request that commenters provide any quantitative data they may have on the likely behavior of investors in response to our proposals.

Currently, funds with class C shares typically do not charge a CDSL after the first year, which allows the potential for some short-term shareholders in C share classes to redeem soon after purchase and pay less asset-based distribution fees compared to longer -term shareholders in the same share class. Essentially, the longer-term C class shareholders subsidize some of the distribution expenses of the shorter-term shareholders. Funds typically structure their C shares in this manner to attract investors who may not want to be committed to a long-term investment in a fund, and who may pay significantly more or less in distribution costs depending on how long they remain invested in the fund. Funds also take the risk that the distribution expenses associated with short-term investments in C shares will not be balanced out by long-term C class shareholders who may pay significantly more in asset-based distribution fees than if they had instead invested in some other class.

Proposed new rule 12b-2 and amended rule 6c-10 would have the effect of limiting the total asset-based distribution fees that long-term shareholders would pay, and may thereby alter the economic incentives involved in structuring a C share class without a CDSL. If the proposal is adopted, some funds may reconsider the economics of C share classes, and could restructure those classes, perhaps imposing a CDSL similar to B share classes. If this occurs, this could effectively eliminate the opportunity for some short-term C class shareholders to avoid paying a portion of the distribution expenses associated with their investment. However, it would also effectively eliminate the potential for some longer-term shareholders in C classes to subsidize those costs by paying significantly more in asset-based distribution fees over time. One of the goals of this rulemaking is to help ensure more equity between shareholders in the payment of fund distribution expenses. However, we acknowledge that achieving this more equitable treatment between shareholders may come at a cost to certain short-term shareholders whose distribution expenses would no longer be subsidized by long-term C class shareholders.

We request comment on the likelihood of funds restructuring their C share classes as discussed above, and any potential impact such a restructuring might have on both long- and short-term investors in those classes.

- In particular, we request comment on any quantitative estimates of the amount of additional asset-based distribution fees that short-term investors may pay and the amount of such fees that long-term shareholders may save as a result of this proposal.

F. Ongoing Sales Charge: Intermediaries

Broker-dealers and other intermediaries may also be affected by the proposed limitations on ongoing sales charges. Currently, FINRA rules do not limit the total amount of asset-based sales charges that an individual fund investor may pay. NASD Conduct Rule 2830 limits the aggregate amount of these fees and other sales loads that a fund may pay to its distributor, to a percentage of the amount of gross new sales of fund shares. Because most funds continually sell new shares (and thus have new sales), we understand that most funds do not reach this limit. As a result, broker-dealers generally may receive asset-based sales charges on an investment in fund shares for as long as the investor holds the shares (or, in the case of B shares, until the shares convert). The conversion requirements of our ongoing sales charge proposal would limit the amount of asset-based distribution fees that an individual investor would pay to an amount that is tied to the front-end load of the fund, or the NASD sales charge limits.

Our proposed amendments to rule 6c-10 may have the effect of reducing the total compensation that intermediaries receive from the sale of certain types of shares (such as B, C, or R shares). However, as discussed previously, any reduction in compensation would be experienced as reduced costs for investors because distribution charges that are not deducted from fund assets would be retained by shareholders.

The amount of any reduction in intermediary compensation that might result is speculative.[503] For example, many class B shares currently convert on a schedule that generally meets, or come close to meeting, the requirements we propose today. Therefore, we anticipate that complying with the proposal's requirements with respect to class B shares would result in, at most, a minor reduction in compensation to broker-dealers. Class C shares (which are generally described in fund prospectuses as being suitable for short-term investments) do not convert, but if they are sold as short-term investments, we believe they generally would not be held long-term. Based on average holding periods for funds generally, we expect that only a limited portion of outstanding class C shares would be held long enough for any asset-based distribution fees on class C shares to exceed the proposed ongoing sales charge limit.[504]

Funds with class R shares or similar classes (which typically are sold in tax-advantaged accounts and are intended as long-term investments) may charge 12b-1 fees in amounts exceeding 25 basis points that would become subject to the limitations on ongoing sales charges. These share classes often use 12b-1 fees to pay for associated recordkeeping and shareholder

[503] The staff has estimated some potential effects of our rulemaking on investor behavior (and consequent reduction in intermediary compensation) in Section V.E of this Release, *supra*.

[504] Comprehensive data on the typical retention period for C shares is not available, but the typical fund shareholder only holds fund shares for approximately 3-4 years. Based on a front-end load equal to 6%, a C share investor could pay an ongoing sales charge of 75 basis points for approximately 8 years before reaching the ongoing sales charge limits we propose today. This holding period would be more than double the typical holding period for all fund shares, and particularly long for C shares, which funds disclose as appropriate for short-term holding periods.

services, as well as for distribution expenses. As we have discussed above, some funds may be in a position to identify those non-distribution expenses and re-characterize them as administrative fees, thereby avoiding the need to impose an ongoing sales charge without reducing distribution payments to intermediaries. To the extent that any portion of 12b-1 fees currently charged on class R shares must be considered to be an ongoing sales charge, any estimate reduction in compensation resulting from our proposal would be speculative, because as discussed above, we anticipate that the lost revenue may be recovered through other sources.[505]

If intermediaries experience a significant reduction in distribution compensation, would they be likely to renegotiate revenue sharing agreements and recover some or all of the lost compensation through these sources? Would intermediaries be likely to receive less compensation based on the ongoing sales charge limits of our proposal? How much less? Would they make up any or all of any such loss through revenue sharing agreements? Do commenters believe that this reduction in compensation should be treated as a cost of the proposal, considering that any reduction would come with a corresponding increase in the assets held by investors?

Intermediaries such as broker-dealers, banks, and insurance companies may also incur costs in connection with our proposals.[506] For example, these intermediaries may need to enter into new or amended distribution agreements with the funds that they sell, enhance their recordkeeping systems, update sales literature, and provide additional training to their sales representatives regarding the new regulatory framework for mutual fund asset-based distribution

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[505] As discussed above, broker-dealers often receive payments from fund advisers known as "revenue sharing," which supplements the compensation they receive for distributing fund shares. *See supra* note 65.

[506] The costs for retirement plan record keepers are discussed below, and the costs for transfer agents are included in the previously discussed costs for mutual funds above.

fees and the suitability of different share classes for their clients. The staff estimates that there are approximately 4770 of these types of intermediaries, and that approximately 40% of these intermediaries (or 1908) receive 12b-1 fees, and therefore would be affected by our proposal.[507] The staff estimates that, on average, each affected intermediary would expend $50,000 in costs and 100 hours of internal personnel time in response to our proposals.[508] This internal time would include approximately 75 hours spent by professionals such as compliance personnel at a rate of $210[509] per hour and 25 hours spent by inside counsel at a rate of $316 per hour, at a total internal time cost equivalent of $23,650.[510] Therefore, the staff estimates that all intermediaries may incur approximately $95,400,000 in one-time costs and 190,800 hours (at an internal time cost equivalent of $45,124,200 as a result of the proposed new rule and rule amendments).[511]

In addition, our proposal may require intermediaries such as retirement plan administrators or other omnibus account record keepers to begin tracking share lots and managing share conversions. This change may require these intermediaries to invest in new systems or enhance their current record-keeping and back office systems. If a retirement plan

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507 This number consists of the following: 2203 broker-dealers classified as specialists in fund shares, 167 insurance companies sponsoring registered separate accounts organized as unit investment trusts, approximately 2400 banks that sell funds or variable annuities (the number of banks is likely over inclusive because it may include a number of banks that do not sell registered variable annuities or funds, or banks that do their business through a registered broker-dealer on the same premises). This number may be over or under inclusive, because the actual number of intermediaries that would be affected would vary based on the intermediary's business model and whether the intermediary sells funds that deduct 12b-1 fees.

508 We recognize that this average will likely vary significantly, with large intermediaries incurring many times this cost estimate and small intermediaries likely incurring far less.

509 The staff has based the hourly cost estimates for time spent by intermediaries in this section on SIFMA's *Management & Professional Earnings in the Securities Industry 2009*, *supra* note 407, because the staff believes the hourly costs are comparable.

510 These figures are based on the following calculations: ($210 × 75 hours = $15,750); ($316 × 25 hours = $7900); ($15,750 + $7900 = $23,650).

511 These estimates are based on the following calculations: (1908 intermediaries × $50,000 = $95,400,000 in costs); (1908 intermediaries × 100 hours = 190,800 hours expended); (1908 intermediaries × $23,650 = $45,124,200).

offers fund classes that deduct an ongoing sales charge, the proposal would require such shares purchased by plan participants to eventually be converted to a class that does not deduct an ongoing sales charge. This conversion requirement would create costs for retirement plan record-keepers because we understand that currently, most record-keepers do not maintain individual participant share histories. Record-keepers for plans that offer shares classes with an ongoing sales charge would need to begin tracking the date of purchase of each share lot for each participant, and tie that share history to the appropriate conversion date. In addition, plans currently usually only have a single class of shares for each fund offered within the plan. If our proposal is adopted, however, if the single class that is offered within the plan deducts an ongoing sales charge, a second class of shares for each fund (*i.e.* a target class for converted shares) would have to be added to the record-keeper's systems, effectively adding more complexity and costs to their operations. For example, as a result of this increase in the number of shares classes, record-keepers might need to increase the size of their participant statements, spend more time answering participant questions, process more trades, and manage operational complexities related to multiple share classes (such as allocating withdrawals between share classes for participant loans and rebalancings, identifying the correct conversion date for reinvested dividends, and other issues).

Only record-keepers that provide services to retirement plans that offer fund share classes with 12b-1 fees in excess of 25 basis points would be affected by our proposal.[512] The staff estimates that there are approximately 2025 intermediaries that provide record-keeping for retirement plans, and that approximately 25% (or 506) of those record-keepers provide services

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[512] Record-keepers for plans that only offer funds with 12b-1 fees of 25 basis points or less would be generally unaffected by our proposal, because they would not need to change their systems to manage the ongoing sales charge and its related multiple share classes and conversions.

to plans that offer fund share classes with 12b-1 fees in excess of 25 basis points.[513] The staff estimates that approximately 35% (or 177) of the 506 affected record-keepers would choose to upgrade their systems to manage ongoing sales charges, while the other 65% (or 329) would choose to do business only with plans that offer funds without an ongoing sales charge, and thus avoid the costs discussed below.[514] The staff estimates that it would cost a record-keeper approximately $1,000,000 in one-time costs and $1,500,000 annually to manage ongoing sales charges for the plans they service.[515] These expenses would include, but not be limited to, expenses related to enhancing computer software to begin tracking and aging share histories and multiple share classes, additional computer hardware and storage costs for the increased volume of information related to participant positions, larger participant statements (and higher mailing costs), increased time spent providing service to participants, and costs related to managing the operational complexities discussed above. Therefore, the staff estimates that intermediaries that provide record-keeping services to retirement plans may incur a total one-time cost of

[513] This includes 225 bank, mutual fund, and insurance record-keepers, and an additional 1800 third party administrators that provide some record-keeping for the plans they administer. The number of participant accounts serviced by these record-keepers varies widely, with some servicing more than ten million accounts, and others only providing service to a few hundred or thousand accounts. The costs we provide here are estimates for the average record-keeper, and we acknowledge that the larger firms will likely incur significantly higher costs, while the smaller firms may incur far less.

[514] These funds might include funds that have re-assessed the asset-based distribution fees they charge and restructured their fees to identify non-distribution services that could be paid separately from the asset-based distribution fee limits of our proposal, in the manner discussed in Section V.D.2.b of this Release, *supra*.

[515] The staff assumes that record-keepers would continue to receive approximately the same amount of compensation for the services they provide. Record-keepers currently often receive some or all of their compensation from 12b-1 fees deducted from participant funds. The staff expects that much of the compensation that is currently paid to record-keepers through a 12b-1 fee in excess of the marketing and service fee (which would be an ongoing sales charge that would eventually end and no longer be able to pay for record-keeping services) may be re-assessed and paid as an ordinary fund expense, and not be subject to the limits on asset-based distribution fees contained within our proposal.

$177,000,000 and an annual cost of $265,500,000 in complying with our proposal.[516]

As discussed previously, under our proposed rulemaking, ongoing sales charges would qualify as transaction based compensation, and intermediaries who receive the ongoing sales charge may need to register as broker-dealers under section 15 of the Exchange Act unless they can avail themselves of an exception or exemption from registration.[517] The proposed rulemaking could potentially lead to some intermediaries who are currently receiving 12b-1 fees but that are not registered as broker-dealers under section 15 of the Exchange Act to either no longer receive asset-based distribution fees or to register as broker-dealers. However, we understand that virtually all advisers and other intermediaries that currently receive 12b-1 fees in excess of 25 basis points (thus qualifying as an ongoing sales charge) already associate themselves with registered broker-dealers, either by registering themselves, or by becoming an independent contractor registered representative of an registered broker-dealer. Therefore, we do not anticipate that, if our proposal is adopted, any intermediaries who are currently receiving 12b-1 fees would newly register as broker-dealers, and thus incur the costs associated with registration.

We request comment on all of the estimates and assumptions made in this section.

- Is our understanding correct? Would the proposed rulemaking in fact require any intermediaries who are currently receiving 12b-1 fees to register as a broker-dealer? In particular, we request comment on what types of intermediaries, if any would be affected, and if they are affected, how many would be required to register or no longer receive ongoing sales charges. If intermediaries are required to register, what

[516] These estimates are based on the following calculations: (177 record-keepers × $1,000,000 one-time costs = $177,000,000 in one-time costs); (177 record-keepers × $1,500,000 in annual costs = $265,500,000 in annual costs).

[517] *See supra* note 168.

kind of costs would they incur? We currently estimate that any new entities registering as broker-dealers would incur a time burden of 2.75 hours to complete Form BD.[518] Are there other costs that would be implicated by broker-dealer registration? Would other burdens be incurred and, if so, what are those burdens? What one-time and on-going costs, if any, would be incurred? We request comment on the estimates and assumptions we have made in this section.

G. Disclosure

The proposal would make the following changes to the disclosure requirements:

- Amend Form N-1A to replace the current line item for 12b-1 fees in the fee table and statement of operations with two new line items ("Marketing and Service Fee" and "Ongoing Sales Charge") and revise most of the current disclosure in the prospectus and SAI related to the discussion of 12b-1 plans (which would no longer exist) and the dollar amounts spent under the plans for different distribution activities;
- Eliminate the periodic reporting requirement related to 12b-1 plans in Form N-SAR, the annual and semi-annual reporting form used by mutual funds;
- Amend the statement of operations for fund income and expenses in Regulation S-X to conform to our proposal;
- Amend Forms N-3, N-4, and N-6 to conform to our proposed changes; and
- Provide better proxy disclosures for shareholder votes on asset-based distribution fees.

These proposed disclosure changes would provide a number of benefits, including providing more descriptive disclosure of the use and amount of asset-based distribution fees deducted by funds in prospectuses and SAIs, providing greater transparency of these fees to investors, removing requirements that would become outdated, and conforming disclosure

[518] Form BD is the application form used by entities to apply to the Commission for registration as a broker-dealer. *See* Proposed Collection; Comment Request (Apr. 20, 2010) [75 FR 22638 (Apr. 29, 2010)] (providing estimates of and seeking comments on compliance burden of Form BD).

requirements to our proposal. We have discussed these benefits in detail previously in this Release in Sections III.I and III.M above. These benefits include providing clearer disclosure of the amount and use of asset-based distribution fees, eliminating potentially confusing or unnecessary disclosure, and providing better descriptions of the fees. The amendments would provide investors access to more relevant and transparent information that could help guide their investment making decision when considering whether to invest in a fund that deducts asset-based distribution fees. As discussed below, the staff estimates that there would be no additional ongoing costs as a result of these disclosure changes, and in fact, those ongoing costs may decrease.

1. Revised Fee Table, Prospectus, and SAI Disclosure

The proposal would require funds to eliminate the current line item titled "Distribution and/or Service (12b-1) Fees" and add, as necessary, two items for the fees permitted under the proposal – "Marketing and Service Fee" and "Ongoing Sales Charge." Funds that do not currently charge asset-based distribution fees would not be affected by these proposed amendments. The staff estimates that funds that charge asset-based distribution fees would be able to complete the revised fee table in the same amount of time, and for the same cost because the revised fee table only includes data that is readily available when the fund regularly updates the fee table, and does not include any new information. The revised fee table would not be significantly longer, and would instead simply include a new line item, which is a breakdown of an existing line item, that was already known when the fee was instituted.[519] Therefore, the staff estimates that the proposed new line items in the fee table would not increase costs or the amount

[519] There are two types of Form N-1A filings; (i) initial filings, and (ii) annual post-effective amendments. Funds usually incur significantly more time and incur greater costs when first registering a fund under their initial N-1A filings than when filing their annual post-effective updates. Therefore, the staff separately estimates the burden for each type of filing.

of time required to complete Form N-1A, either initially or when submitting a post-effective amendment.

The proposal would also significantly revise the disclosure required for funds with 12b-1 fees in the prospectus narrative and in the SAI. These proposed amendments would eliminate many disclosures that would become outdated or irrelevant based on our proposed rule changes, including some of the most detailed disclosures of the dollar amount the fund spends on each distribution activity. However, some of the other disclosure requirements regarding asset-based distribution fees currently in Form N-1A would be retained in the same or similar form.[520] Thus, we anticipate that the proposed amendments would reduce the amount of time needed to provide disclosure on asset-based distribution fees on an ongoing basis, although some one-time costs may be incurred to initially revise and update the prospectus to conform its description regarding asset-based distribution fees to the proposed new framework.

In our most recent Paperwork Reduction Act submission for Form N-1A, the staff estimated that for each fund portfolio or series, the initial filing burden is approximately 830.47 hours at a cost of $20,300, and the post-effective amendment burden is approximately 111 hours at a cost of $8894. This includes time spent by inside counsel, back office personnel, compliance professionals, and others in filling out the form. The costs include that of outside counsel to prepare and review these filings. We assume that only funds that charge asset-based distribution fees would be affected by our proposed amendments to Form N-1A. The staff estimates that, each year, there are approximately 7367 funds with 12b-1 plans that file post-effective amendments.

The staff estimates that our proposed amendments would result in time savings of

[520] *See* Section III.J, *supra*.

approximately 10 hours for each portfolio's initial filing (for a new total estimate of 820.47 hours) and of 1 hour for each post-effective amendment (for a new total estimate of 110 hours). The staff further estimates that the amendments would reduce costs spent on outside counsel, and other costs associated with completing Form N-1A, by $500 for each initial filing (for a new total estimate of $19,800) and $150 for each post-effective amendment (for a new total estimate of $8744). In addition, the staff estimates that each fund would incur a total one-time cost of $2000 and a one-time time expenditure of 10 hours of attorney time at a rate of $316 per hour to initially revise their post effective amendments to Form N-1A to meet the requirements of the proposed amendments for the first time.

The staff estimates that, in each year following the effective date of the proposed amendments, 300 additional funds with asset-based distribution fees would file an *initial* Form N-1A. Based on these estimates, the staff estimates that funds would save a total of 3000 hours (at an internal time cost equivalent of $948,000)[521] and $150,000 when submitting initial Form N-1A filings each year.[522] In addition, the staff anticipates that funds would save approximately 7367 hours (at an internal time cost equivalent of $2,327,972)[523], and $1,050,050 annually when preparing post-effective updates to Form N-1A.[524] Finally, the staff estimates that all funds with asset-based distribution fees would incur a total one-time expenditure of 73,670 hours (at an internal time cost equivalent of $23,279,720) and a cost of $14,734,000 when preparing post-

521 This estimate is based on the following calculation: (300 new filers × 10 hours savings = 3000 hours in total savings); (3000 hours × $316 per hour = $948,000).

522 This estimate is based on the following calculations: (300 new filers × $500 savings = $150,000 total savings).

523 This estimate is based on the following calculation: (7367 amendments × 1 hour savings = 7367 hours in total savings); (7367 hours × $316 per hour = $2,327,972).

524 This estimate is based on the following calculations: (7367 amendments × $150 savings = $1,105,050 total savings).

effective amendments to comply with the proposed amendments for the first time.[525]

- We request comment on these estimates and assumptions.

2. N-SAR Periodic Reporting

Our proposal would amend the instructions to Form N-SAR, which currently requires funds to respond to a series of questions regarding their 12b-1 plans. Form N-SAR is the form that registered investment companies use to make periodic reports to the Commission. Our proposed amendments would add an instruction to Form N-SAR to disregard, for funds that no longer have 12b-1 plans, four questions (Items 41-44) that relate to the operation of rule 12b-1 plans (because they would be irrelevant in light of our proposed new framework for asset-based distribution fees). However, funds that maintain grandfathered fund classes would continue to respond to these items.

The staff estimates that there are approximately 1292 management investment companies that respond to Items 41-44 of Form N-SAR. The staff estimates that our proposed amendments would reduce the time it takes funds that do not have grandfathered share classes to complete Form N-SAR by 0.25 hours, and that there would be no change for funds that maintain grandfathered share classes. The staff estimates that, if these amendments are adopted, in the first three years after adoption, approximately 20% of these 1292 management investment companies (or 258) would no longer maintain grandfathered share classes and would then experience the estimated savings, while the remaining 80% (or 1034) would continue to have grandfathered share classes and respond to these items. Because Form N-SAR is completed twice a year, the staff estimates that each respondent would save approximately 0.5 hour

[525] This estimate is based on the following calculations: (7367 amendments × 10 hours expended = 73,670 hours); (73,670 hours x 316 per hour = $23,279,720); (7367 amendments × $2000 costs = $14,734,000 total one-time costs).

annually (at an internal time cost equivalent rate of $316 per hour). The staff therefore estimates that our proposed amendments to Form N-SAR would result in total incremental time savings of approximately 129 hours (with a total internal time equivalent cost savings of $40,764)[526] annually.

- We request comment on these estimates and assumptions.

3. Regulation S-X

As discussed in Section III.L of this Release, we are proposing changes to rule 6-07 of Regulation S-X, which requires funds to file a statement of operations listing income and expenses, and state separately all amounts paid in accordance with a 12b-1 plan. Our proposal would conform the disclosure requirement to the terms of our proposed new rule and rule amendments regarding asset-based distribution fees, by requiring that funds state separately amounts charged for marketing and service fees and ongoing sales charges.

Our understanding is that funds already have information on asset-based distribution fees available in order to prepare the statement of operations as we have proposed. Funds analyze this information as a matter of course for ordinary business and tax reasons, and therefore our proposed changes to Regulation S-X would not require the preparation of new information. Accordingly, the staff estimates that our proposed changes to Regulation S-X would not change the amount of time or the costs required for funds to prepare their statements of operations under the regulation.

- We request comment on these estimates and assumptions.

4. Form N-3, N-4, and N-6

The proposal would revise the currently required disclosure for 12b-1 plans in the

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[526] This estimate is based on the following calculation: (258 × 0.5 hours = 129 hours); (129 hours × $316 per hour = $40,764).

prospectus narrative and in the SAI of Form N-3. These proposed amendments would eliminate disclosures that would become outdated or irrelevant based on our proposed rule changes, including some of the most detailed disclosures of the exact dollar amount the registrant spends on each distribution activity. However, much of the general disclosures regarding asset-based distribution fees currently in Form N-3 would be retained in the same or similar form.[527]

In our most recent Paperwork Reduction Act submission for Form N-3, the staff estimated that for each portfolio, the initial filing burden is approximately 922.7 hours at a cost of $20,300, and the post-effective amendment burden is approximately 154.7 hours at a cost of $7650. This hourly burden includes time spent by in-house counsel, back office personnel, compliance professionals, and others in preparing the form. The costs include that of outside counsel to prepare and review these filings.

The staff assumes that only registrants that charge asset-based distribution fees would be affected by our proposed amendments to Form N-3. Based upon a review of filings with the Commission, the staff estimates that 1 registrant that currently files on Form N-3 charges asset-based distribution fees, and would file a post effective amendment. The staff estimates that it would cost this registrant approximately $2000 in one-time costs (for outside legal counsel drafting and review) and require an expenditure of 10 hours in internal personnel time (at an internal time cost equivalent rate of $316 per hour) to revise its prospectus to comply with the proposed amendments. The staff further estimates that the proposed amendments to Item 21 and instruction 5 of Item 26 would result in time savings when completing a post-effective amendment of Form N-3. The staff estimates that this registrant would save approximately 1 hour (at an internal time cost equivalent of $316 per hour) annually as a result of the proposed

[527] *See supra* Section III.L.

amendments.

The staff further estimates that no new registrants that file on Form N-3 are likely to charge asset-based distribution fees under proposed rule 12b-2 and the proposed amendments to rule 6c-10. Accordingly, the staff estimates that there will be no other changes in burden hours or costs as a result of the proposed rule and rule amendments.

- We request comment on any of these estimates or assumptions.

Our proposal would also amend Forms N-4 and N-6 to conform them to the new rule and rule amendments that we are proposing today.[528] The proposed form amendments would replace references to rule 12b-1 with references to proposed rules 6c-10(b), 12b-2(b) or 12b-12(d), as appropriate. We expect this would benefit investors because it would more accurately describe these fees.

The staff estimates that the proposed amendments to these forms would not change current estimates of the amount of time or costs associated with completing the forms because they are primarily technical and only conform the disclosure to the proposal. Therefore, we estimate no costs will result from these proposed Form N-4 and N-6 changes.

- We request comment on these estimates and assumptions.

5. *Streamlined Proxy Procedure*

Our proposal would eliminate a number of disclosures in Schedule 14A (the form for proxy statements) that would become irrelevant in light of the proposed rule and rule amendments.[529] We anticipate that the proposed amendments would result in cost savings to

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[528] Form N-3 is used by separate accounts offering variable annuity contracts that are registered as management investment companies. Form N-4 is used by separate accounts offering variable annuity contracts and are registered as unit investment trusts. Form N-6 is used by separate accounts offering variable life insurance contracts and are registered as unit investment trusts.

[529] *See* proposed Item 22 of Schedule 14A.

funds that prepare such proxies when obtaining shareholder consent to increase or implement marketing and service fees.

Funds that rely on proposed rule 12b-2(d) would not be permitted to institute new 12b-1 plans or increase the rate of a 12b-1 fee under an existing plan after the rule's compliance date, and therefore they would no longer solicit proxies in relation to their 12b-1 plans. Proposed rule 12b-2(b) would require a shareholder vote and attendant proxy solicitation when a fund institutes or increases a marketing and service fee in existing share classes.[530]

Commission staff estimates that approximately 3 funds would solicit proxies each year for the purposes of implementing or increasing a fee under proposed rule 12b-2(b) (the same number that we have previously estimated would solicit proxies under rule 12b-1). Funds typically hire outside legal counsel and proxy solicitation firms to prepare, print, and mail these proxies. For each of these 3 funds, the staff estimates that our proposed amendments to Schedule 14A would result in an incremental burden reduction of 3 hours of internal personnel time (at an internal time cost equivalent rate of $316 per hour) and reduced costs of $400 for the services of outside professionals. The staff therefore estimates that these amendments will reduce the total annual costs of soliciting proxies and completing Schedule 14A by approximately 9 hours of internal personnel time (3 funds x 3 hours) at a internal time cost equivalent of $2844[531] and approximately $1200 (3 funds x $400) for the services of outside professionals.

H. Account-level Sales Charge Alternative

Proposed rule 6c-10(c) would provide funds the option of offering a class of fund shares that could be sold by dealers with sales charges set at negotiated rates. The sales charge could

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530 As discussed in Section III.N.4 of this Release, *supra*, we would not require a shareholder vote if a 12b-1 fee is relabeled a marketing and service fee, provided the fee is 25 basis points or less and is not increased.

531 This estimate is based on the following calculation: (9 hours × $316 per hour = $2844).

vary in amount, or time of payment, and could better reflect services provided by the broker. We assume that a limited number of funds would choose to rely on this exemption immediately, and that reliance on the exemption may increase over time as funds and dealers better understand the costs and benefits associated with a different business model.

1. Benefits

Some of the benefits that may derive from this exemption include enhanced competition in fund distribution, greater transparency of distribution charges for fund investors, and reduced conflicts for broker-dealers selling funds with different compensation structures.[532] Other benefits include less complicated distribution structures and reduced training required for registered representatives of broker-dealers. This part of the proposal could also prompt new innovative fund distribution systems and allow the development of new business models. We discuss the many other potential benefits of this proposal in detail in Sections III.I and III.M above.

2. Costs

Proposed rule 6c-10(c) is elective, and thus only funds or dealers that choose to rely on it would incur the costs of complying with its conditions. Proposed rule 6c-10(c) requires a fund that chooses to rely on the exemption to meet the following two conditions: (i) the fund must not deduct an ongoing sales charge pursuant to proposed rule 6c-10(b); and (ii) the fund must disclose that it has elected to rely on the exemption in its registration statement. The first condition (prohibiting funds from deducting an ongoing sales charge) should not impose any costs on funds. We expect that any fund that relies on proposed rule 6c-10(c) would do so as

[532] We have not received any applications for an exemption from section 22(d) that are similar to our proposal, so we assume the proposal would not result in cost savings related to reduced preparation and processing of exemptive applications.

part of the creation of a new fund or fund class, and that therefore no funds with ongoing sales charges would incur costs in eliminating these charges.

We estimate that funds may incur some minor costs in complying with the second condition, the requirement to disclose the election to rely on proposed rule 6c-10(c) in their registration statement. The staff estimates that to make the required disclosure on the registration statement it would require one hour of time spent by outside counsel, charged at the rate of $400 per hour. Once the disclosure has been initially made on the registration statement, the staff estimates that there would be no further costs or time to update or revise the election, and therefore there would be no annual costs. Thus, the staff estimates that the cost of complying with the conditions in relying on rule 6c-10(c) would be a one-time initial cost of $400 per fund. The staff estimates that between 10 and 100 new funds might rely on proposed 6c-10(c) for the first time each year, and therefore estimate that the total costs for all funds to comply with the proposed exemption would be between $4000 and $40,000[533] in one-time costs (to newly formed funds) each year.

We anticipate that funds that rely on proposed rule 6c-10(c) would do so as part of a decision to provide competitive alternatives to other distribution models, and that any other costs not imposed by the conditions of the rule to establish the structure would be justified by the anticipated benefits accruing to the fund. Other such costs to establish the new distribution structure might include setting up new classes of the fund, negotiating new distribution agreements with broker-dealers, and educating investors and financial representatives about the

[533] This estimate is based on the following calculations: (10 funds × $400 = $4000; 100 funds × $400 = $40,000).

new fee structure.[534] The decision to rely on the proposed rule would be driven by business factors, and the potential for new markets and customers. Funds and broker-dealers that do not choose to rely on this exemption would not bear any costs related to the proposed rule.[535]

We request comment on the discussion of the costs and benefits of our proposed rule 6c-10(c).

- Are there any costs that this exemption would impose on funds or others? What other benefits might it provide? What should we assume about the compensation structure that brokers would design? How many funds are likely to take advantage of this exemption, and what kind of factors would drive this choice? What kind of costs would these funds incur? Are our estimates of the cost of complying with the conditions of the exemptions reasonable?

As discussed previously, our experience with unfixing commission rates leads us to expect that when sales loads are subject to market pressure, sales loads will go down for all investors. However, we acknowledge the potential that some investors (perhaps due to a lack of bargaining power) may pay higher sales loads under proposed rule 6c-10(c) than they might have under the fixed sales load regime of section 22(d). We request comment as to whether investors are likely to pay lower (or higher) sales loads if they purchase fund shares from a fund taking advantage of the proposed exemption.

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[534] Based on discussions with one fund, that fund suggested that these and similar efforts could include one-time costs of $550,000 and ongoing costs of $250,000 annually per fund family.

[535] Broker-dealers could face certain difficulties related to "investor portability" or account transfers for investors in classes that rely on the proposed rule. Broker-dealers may encounter recordkeeping or other issues when an investor account that holds fund shares in such a class is transferred to a broker-dealer that only sells shares of the fund with asset-based distribution fees. Broker-dealers currently face this issue when transferring investor accounts today (if, for example, the transferred account includes shares of a fund that the new broker-dealer does not sell), although it may be exacerbated by the different fee structure the exemption offers.

- Are investors likely to experience any other costs or benefits as a consequence of the proposed exemption? If the exemption is widely relied upon, what might be the effect on distribution arrangements, and on distributors that do not rely on the rule?

I. Director Responsibilities

Board of directors' responsibilities would change under the proposal because we would not require directors to adopt and annually renew a 12b-1 plan or make any special findings.[536] The proposal would not impose other procedural requirements currently in rule 12b-1, including the requirements for quarterly review. Although the proposal would eliminate director specific oversight requirements, directors would still have a fiduciary obligation to consider whether the asset-based distribution fees are in the best interest of the fund and fund shareholders.

1. Benefits

We expect that the proposed reduction in formal requirements regarding the approval of asset-based distribution fees would result in significant cost and time savings for funds and their investors. The staff has estimated in our most recent Paperwork Reduction Act analysis for rule 12b-1 that, for each fund family that has at least one fund with a 12b-1 plan, it takes approximately 425 hours for the fund's directors, counsel, accountants, and other staff to maintain the plan, prepare and evaluate quarterly reports, make the necessary findings, and hold director votes, at an internal time cost of $99,811 per fund family. The staff estimates that there are approximately 379 fund families with at least one fund that charges 12b-1 fees. Therefore, the staff estimates that for all fund families with a 12b-1 plan, funds expend a total of 161,075

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[536] Our proposed rescission of rule 12b-1 would also eliminate the recordkeeping requirements in rule 12b-1(f) to maintain copies of the plan, reports or any other agreements related to the plan. Although our proposal would not impose recordkeeping requirements, we do not anticipate that funds would realize any cost savings as a result of this amendment, because they would continue to maintain records regarding their asset-based distribution fees to prepare their financial statements.

hours at an internal time cost of $37,828,369.[537]

The staff estimates that our proposal would reduce this burden by approximately 75% (proportionately for all fund employees) for an annual hour reduction for each fund family of 319 hours, and a $74,858 reduction in internal costs.[538] If our proposal is adopted, we estimate that funds, their employees (or the employees of the adviser), and directors would only need to spend 106 hours instead of 425 hours annually on asset-based distribution fee matters pursuant to rules 12b-2 and 6c-10, at an internal cost of $24,953 instead of $99,811.[539] Therefore, the staff estimates that our proposed amendments to director responsibilities and the proposed removal of rule 12b-1 would reduce this total time from a total of 161,075 hours per year at an internal cost of $37,828,369, to 40,269 hours at an annual cost of $9,457,092[540] resulting in an annual savings of 120,806 hours and $28,371,277 dollars.[541]

- We request comment on these estimates and assumptions.

2. Costs

Other than the time expenditures we have outlined previously in this analysis, we do not expect that there will be any costs associated with our proposed removal of rule 12b-1 and clarification of director responsibilities in our proposal. As discussed above, we anticipate that the proposed changes would simplify the requirements for imposing asset-based distribution fees

537 These estimates are based on the following calculations: (425 hours x 379 fund families = 161,075 hours; $99,811 x 379 fund families = $37,828,369).

538 This estimate applies to both funds that deduct asset-based distribution fees under proposed rules 12b-2(b) and 6c-10, and to funds that deduct grandfathered 12b-1 fees pursuant to proposed rule 12b-2(d).

539 These estimates are based on the following calculations: (425 hours x 25% = 106 hours; $99,811 x 25% = $24,953).

540 These estimates are based on the following calculations: (161,075 hours x 25% = 40,269 hours; $37,828,369 x 25% = $9,457,092).

541 These estimates are based on the following calculations: (161,075 hours x 75% = 120,806 hours; $37,828,369 x 25% = $28,371,277).

compared to the current requirements of rule 12b-1. Costs that a fund might incur in connection with revising disclosures regarding asset-based distribution fees are discussed above.[542]

- We request comment on these estimates and assumptions.

J. 11a-3 Amendments

We are also proposing to amend rule 11a-3 (which governs sales loads on offers of exchange within a fund family) to bring it into conformity with the proposed treatment of ongoing sales charges we describe in this Release. The proposed amendments would require funds to give shareholders "credit" against the rate of any sales load owed for ongoing sales charges paid by investors who exchange fund shares within a fund group.[543]

1. Benefits

We anticipate that the proposed amendments to rule 11a-3 would provide a number of benefits. Some of the principal benefits include more equitable treatment of investors who pay sales charges, whether with the initial investment, or over time, and greater transparency in sales charges paid.

2. Costs

Based on conversations with industry representatives, the staff understands that most funds that currently rely on the exemptive relief provided by rule 11a-3 have systems that can credit ongoing sales charges in the way the proposed amendments would require. In order to process credits for CDSLs (and other purposes), funds (or their transfer agents) use a bucketing system that allows them to track the history of fund shares. The staff understands that these existing systems can track the length of time shares subject to an ongoing sales charges have been held, determine the charges that have been paid, and credit those charges against any load

[542] *See supra* Section V.G of this Release.

[543] A more detailed description of these amendments is included in Section III.K of this Release, *supra*.

imposed on the new shares acquired in an exchange. The staff understands that most funds generally limit exchanges to shares of the same class in other funds within the fund group. As a result, when transferred, the ongoing sales charge and conversion date of both the exchanged and acquired shares would generally be the same, if the maximum sales load remains the same. In those circumstances, no action would be required on the part of the fund or its transfer agent. Alternatively, the conversion date may need to be changed (if, for example, the maximum sales loads of the two funds are different). We expect that most funds should be able to comply with our proposed 11a-3 amendments with little difficulty.

Funds may still need to update their systems for share exchanges and enhance their capacity to include shares with ongoing sales charges. The staff therefore estimates that a typical fund family with funds that deduct ongoing sales charges (or the fund's transfer agent) would incur $25,000 in one-time costs to update its systems to comply with our proposed amendments. For purposes of this analysis, the staff assumes that all 196 fund families that may be affected by our ongoing sales charge proposal would incur this cost, for a total cost of $4,900,000.[544]

- We request comment on these estimates and assumptions.

K. Other Technical Amendments

Our proposal would make a number of technical amendments to Investment Company Act rules and forms, removing current references to rule 12b-1 and adding references to the appropriate proposed rule.[545] We do not expect these changes to materially affect funds, intermediaries, or others, because they are technical changes that should not affect fund

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544 This estimate is based on the following calculation: (196 fund families × $25,000 = $4,900,000).

545 These proposed technical amendments would affect rules 17a-8, 17d-3, 18f-3, and Regulation S-X under the Act. For a complete discussion of the changes, *see* Section III.L of this Release, *supra*.

operations. Therefore, we do not believe that there would be any costs associated with these amendments. We request comment on this assumption.

- Would there be any costs associated with making the technical changes described in Section III.L above?

L. Rule 10b-10

The proposed amendments to Exchange Act rule 10b-10 would provide broker-dealer customers with additional information related to mutual fund costs and callable securities.

1. Benefits

The improved disclosure related to mutual fund costs could be expected to help make the confirmation a more complete record of the transaction and help mutual fund investors more fully understand the sales charges they incur. Those improved disclosures could be expected to promote decision making by investors that more appropriately takes those costs into account. Those improved disclosures also could be expected to assist investors in verifying whether they paid the correct sales charge set forth in the prospectus. The improved disclosure related to callable debt securities could be expected to help alert investors to misunderstandings, avoid confusion, promote the timely resolution of problems, and better enable investors to evaluate potential future transactions.

2. Costs

These proposed amendments to rule 10b-10 would require brokers-dealers to include additional information in confirmations that are currently sent to investors. The costs of adding this new information into confirmation disclosures would largely be expected to be one-time programming-related costs, borne primarily by clearing firms and third-party service providers, which are included in the estimates of the Paperwork Reduction Act burden. For purposes of the

Paperwork Reduction Act, the Commission staff has estimated that the one-time burden to clearing firms with proprietary systems to reprogram software and otherwise update their systems to enable them to generate confirmations meeting the requirements of the proposed amendments would be approximately 720,000 hours.[546] The staff estimates that this one-time burden would equal total internal costs of approximately $180.7 million dollars,[547] or $1.1 million per vendor.[548] The staff also estimates that vendor licensors of platforms would incur costs equivalent to those incurred by clearing firms with proprietary systems, resulting in one-time burden of 13,500 hours and costs of approximately $3.4 million dollars,[549] or $1.1 million per vendor.[550] In addition, the staff understands that clearing firm licensees would incur an additional 800 burden hours each, or 296,000 total, for a total cost of approximately $74.3 million,[551] or $200,800 per clearing firm licensee.[552]

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546 4500 burden hours x 160 clearing firms with proprietary systems = 720,000 burden hours. *See* note 437 *supra* and accompanying text.

547 720,000 hours x $251 dollars per hour = $180,720,000. These figures are based on an estimated hourly wage rate of $251. The estimated wage figure is based on published compensation for compliance attorneys ($291) and the average costs of a senior computer programmer ($285) and a computer programmer analyst ($190) (($190 + $285) ÷ 2 = $238). *See* Securities Industry and Financial Markets Association, *Management and Professional Earnings in the Securities Industry* (Sept. 2009). The staff estimates that programmers would utilize 75% of the burden hours to implement system changes while attorneys would utilize 25% of the burden hours to review the output, yielding a weighted wage rate of $251 dollars per hour (($291 x .25) + ($238 x .75)) = $251).

548 4500 burden hours x $251 dollars per hour = $1,129,500.

549 3 vendors x 4500 burden hours x $251 dollars per hour = $3,388,500. For purposes of this analysis, the staff assumes that vendors would incur the same per hour costs and burden hours incurred by clearing firms with proprietary systems. *See* note 438 *supra*.

550 4500 burden hours per vendor x $251 dollars per hour = $1,129,500.

551 370 clearing firm licensees x 800 burden hours x $251 dollars per hour = $74,296,000. For purposes of this analysis, the staff also assumes that vendors or other third-parties would perform the work needed to adapt each of these clearing firms' systems to the changes made to its vendor's platform. The staff further assumes the hourly costs to clearing firms to outsource these additional burdens to third-parties would be equivalent to the hourly costs incurred by vendors and by clearing firms with proprietary systems. This hourly cost is estimated at approximately $251 per hour. *See* note 438 *supra*.

552 800 burden hours per clearing firm licensee x $251 per hour = $200,800.

When we include the costs borne by vendors and clearing firm licensees, we estimate that that the total one-time burden as a whole would be approximately $258.4 million dollars.[553]

- We request comment on these estimates and assumptions.

M. Total Costs and Benefits

As discussed above, we have designed our proposal to minimize the cost impact on funds, intermediaries, and service providers while maximizing the investor protection and other benefits. The staff anticipates that funds representing approximately 93% of all assets under management will incur minor or no expenses in complying with our proposal.[554]

The staff estimates that the total one-time costs of compliance with our proposed amendments would be $400,994,000 in outside expenses and $362,348,000 in internal time cost equivalents. The staff further estimates the total annual costs of compliance would be $304,076,000. The staff also estimates that the total annual benefits of compliance with our proposed amendments would be between $1,062,361,000 to $1,258,361,000 in cost savings and $31,963,000 in internal time cost equivalents. This does not reflect our full expectation of the costs and benefits of the proposed amendments because many of the expected costs and benefits are qualitative in nature.

- We request comment on these estimates.

N. Request for Comment

We request comments on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of, or suggested alternatives to, the proposed amendments.

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553 ((3 vendors x 4500 burden hours) + (370 clearing firm licensees x 800 burden hours) + (160 clearing firms with proprietary systems x 4500 burden hours)) x $251 per hour = $258,404,500. As discussed above, the staff believes that all parties would incur costs of $251 per hour.

554 *See supra* Section V.B of this Release.

Commenters are requested to provide empirical data and other factual support for their views to the extent possible. In particular, we request comment on the quantitative estimates made within this section and any other costs or benefits that were not discussed here that might result from the amendments. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits.

VI. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to the Commission's proposed removal of rule 12b-1, new rule 12b-2, and amendments to rules 6c-10, 10b-10, 11a-3, 17a-8, 17d-3, and 18f-3, and amendments to Forms N-1A, N-3, N-4, N-6, N-SAR and Regulation S-X and Schedule 14A, under the Securities Act, the Securities Exchange Act, and the Investment Company Act.

A. Reasons for, and Objectives of, the Proposed Actions

As more fully described in Sections I, II, and III of this Release, we are proposing a new rule and rule and form amendments designed to address funds' use of asset-based distribution fees, to amend our current regulations to reflect current economic realities and the role of directors regarding these charges, and to enhance transparency and equity of these fees for investors. Rule 12b-1, the current rule that governs the use of asset-based distribution fees, relies on fund directors to oversee the level and use of these fees. Asset-based distribution fees have evolved into a substitute for front-end loads, and have also enabled the development of new models of fund distribution that could not have been anticipated when the rule was adopted. Small funds, in particular, often rely on asset-based distribution fees as a means of gaining access to distribution channels that would not otherwise be available to them.[555]

The proposal is also designed to improve investor understanding of these fees and their purposes, as well as to enhance equity in the amount of distribution costs all fund shareholders pay, regardless of the method of payment. Currently, investors may not understand that asset-based distribution fees are the equivalent of sales loads, and some investors may believe that they have avoided a sales load entirely by purchasing a share class that charges an asset-based distribution fee. In addition, under current distribution practices, certain long-term shareholders that pay asset-based distribution fees may subsidize the distribution expenses of other shareholders in the fund. As a result, some fund shareholders may pay a disproportionate amount of the fund's distribution expenses.

Our proposed new rule, and rule and form amendments, would significantly revise our current regulations regarding asset-based distribution fees by eliminating the specific requirements for the board of directors. The proposal would recognize that funds bear ongoing expenses that, although they are distribution related, may benefit the fund and fund shareholders, and would replace the specific formal requirements for the board with other regulatory protections. In particular, the proposal would recognize that asset-based distribution fees may be used as a substitute for a sales load, and would regulate them in a similar manner. We expect that this would give directors more time to focus on other important fund matters. In order to provide greater equity among shareholders who bear distribution fees, the proposal would limit the amount of asset-based distribution fees that may be charged to each investor. Funds would be required to convert shares that have an ongoing sales charge to a class that does not impose an

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555 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 67-68 (statement of Mellody Hobson, Ariel Capital Management, LLC), and discussion of the impact of the proposal on small funds, Section III.M, *supra*.

ongoing sales charge no later than when the cumulative charges equal the amount of the highest front-end load that the investor would have paid had the investor invested in another class of shares in the same fund, or after a set conversion period based on the rate of the front-end load and the rate of the ongoing sales charge imposed.

In addition, the proposal would allow funds that deduct a marketing and service fee pursuant to rule 12b-2 to sell their shares at other than the public offering price as disclosed in their prospectus. This would enable funds to offer new choices to investors in paying for the costs of distribution; enhance competition in pricing between broker-dealers in the sale of fund shares; and present new business opportunities to funds that choose to use this exemption. We believe small funds may be the funds that are more likely to so experiment and use this exemption to expand their market opportunities.

Finally, the proposal would also make a number of changes to current disclosure requirements designed to enhance investor understanding of these fees. In particular, the proposal would require the prospectus fee table to state separately (i) the amount of asset-based distribution fees that pays for services received by shareholders in the fund and for other general distribution purposes (the marketing and service fee), and (ii) the amount of asset-based distribution fees that are a substitute for a sales load (the ongoing sales charge). This disclosure is designed to allow fund shareholders to understand better the purpose of these fees, and the amounts they are paying. The proposal would also make a number of conforming changes to other rules and forms that are intended to update current references to rule 12b-1 to reflect the regulations we are proposing today, as well as eliminating or updating requirements that would become irrelevant if our proposal were adopted. The proposal further would make changes to rule 10b-10 to improve disclosure on broker-dealer confirmations of costs related to mutual funds and to make other improvements.

B. Legal Basis

The Commission is proposing amendments to Schedule 14A under the authority set forth in sections 3(b), 10, 13, 14, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78c(b), 78j, 78m, 78n, 78*o,* 78w(a), and 78mm], and sections 20(a), 30(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-20(a), 80a-29(a), and 80a-37(a)]. The Commission is proposing amendments to rule 6-07 of Regulation S-X under the authority set forth in section 7 of the Securities Act [15 U.S.C. 77g] and sections 8 and 38(a) of the Investment Company Act [15 U.S.C. 80a-8, 80a-37(a)].

The Commission is proposing to remove rule 12b-1 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing new rule 12b-2 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing amendments to rule 6c-10 under the authority set forth in sections 6(c), 12(b), 22(d)(iii), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(b), 80a-22(d)(iii) and 80a-37(a)]. The Commission is proposing amendments to rules 11a-3, 17a-8, 17d-3, and 18f-3 under the authority set forth in sections 6(c), 11(a), 17(d), 18(i), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-11(a), 80a-17(d), 80a-18(i) and 80a-37(a)].

The Commission is proposing amendments to Form N-SAR under the authority set forth in sections 10(b), 13, 15(d), 23(a), and 36 of the Securities Exchange Act [15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm], and sections 8, 13(c), 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a-8, 80a-13(c), 80a-24(a), 80a-29, and 80a-37]. The Commission is proposing amendments to registration Forms N-1A, N-3, N-4, and N-6, under the authority set forth in sections 6, 7(a), 10, and 19(a) of the Securities Act [15 U.S.C. 77f, 77g(a), 77j, 77s(a)], and sections 8(b), 24(a), and 30 of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-24(a), and 80a-29]. The Commission is proposing amendments to Exchange Act rule 10b-10 pursuant to the authority conferred by the Exchange Act, including sections 10, 17, 23(a), and 36(a)(1) [15 U.S.C. 78j, 78q, 78w(a), and 78mm(a)(1)].

C. Small Entities Subject to the Rule

For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year. Based on a review of filings submitted to the Commission, approximately 108 investment companies registered on Form N-1A meet this definition. These funds have approximately 189 classes. Commission staff estimates that 40 of these investment companies have at least one class that charges 12b-1 fees, with approximately 78 classes that deduct 12b-1 fees. Of those 78 classes, 23 charge 12b-1 fees in excess of 25 basis points, while the remaining 55 classes charge 12b-1 fees of less than 25 basis points.

For purposes of the Regulatory Flexibility Act, a broker-dealer is a small business if it had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to rule 17a-5(d) of the Exchange Act or, if not required to file such statements, a broker-dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter) and if it is not an affiliate of an entity that is not a small business.[556] The Commission staff estimates that approximately 862 broker-dealers meet this definition.[557] Of these, however, only 17 clearing firms can be classified as small entities that would likely incur the costs of adopting the proposed amendments to rule 10b-10.[558]

D. Reporting, Recordkeeping, and Other Compliance Requirements

Our proposal would amend the reporting, recordkeeping, and other compliance requirements for all funds (including small entities) that comply with rule 12b-1, or would comply with proposed rule 12b-2, proposed amendments to rules 6c-10, 11a-3, 17a-8, 17d-3, and 18f-3, or that would respond to amended Forms N-1A, N-3, N-4, N-6, N-SAR, Schedule 14A and Regulation S-X.[559] We have estimated the costs of these amendments for all marketplace participants previously in the cost-benefit analysis in Section V. above. No new classes of skills would be required to comply with our proposed new rule, or rule and form amendments.

1. *Rule 6c-10*

The proposed amendments to rule 6c-10(b) would allow a fund to deduct asset-based distribution fees from fund assets in excess of asset-based fees permitted under proposed rule 12b-2 (an "ongoing sales charge"), provided shares sold subject to such an ongoing sales charge convert to another class of shares without an ongoing sales charge when the shareholder has paid

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556 17 CFR 240.0–10.

557 This estimate is based on information provided in FOCUS Reports filed with the Commission in 2009.

558 As discussed above, although there are approximately 5035 broker-dealers registered with the Commission to whom the rule would apply, the staff believes that the costs of implementing the proposed changes to rule 10b-10 would be primarily borne by clearing firms Also as discussed above, the staff estimates that there are approximately 530 clearing firms. Based on FOCUS Reports filed with the Commission in 2009, the staff believes that of these 530 clearing firms, approximately 17 come within the definition of a small entity.

559 For a complete discussion of the specifics of the new rule and rule and form amendments, *see* Section III, *supra*.

cumulative charges or rates of fees that are equivalent to what he or she would have paid for shares subject to a front-end sales load. Rule 6c-10(c) would allow funds to sell shares at a price other than described in the prospectus. This provision is an exemption, and thus would not create any new recordkeeping, reporting, or compliance requirements for small entities unless they chose to rely on the exemption.

The proposed amendments would not impose any new reporting obligations on small entities. However, small entities that charge an ongoing sales charge would be required to keep certain new records regarding the length of time that a shareholder holds shares and would be required to comply with the new requirement for conversion of those shares. Commission staff has estimated the costs of these requirements for all funds (including small entities) in the cost-benefit analysis in Section V above. We do not anticipate that small funds would face unique or special burdens when complying with the proposed amendments to rule 6c-10.

2. Removal of Rule 12b-1

We are proposing to remove rule 12b-1. As discussed above, Commission staff has estimated that the proposed removal would reduce costs significantly for affected funds, including the 40 small funds that the Commission staff estimates have at least one class that currently charges 12b-1 fees. The proposal would eliminate existing recordkeeping, reporting, and compliance requirements, and would not create any new ones.

3. Rule 12b-2

The proposal would include new rule 12b-2, which would permit funds to deduct a "marketing and service fee" from fund assets, limited to the amount established in the NASD sales charge rule for "service fees." Any assets a fund deducts in excess of the marketing and service fee would be regulated under rule 6c-10 as an ongoing sales charge. The proposal would also permit funds to continue to charge 12b-1 fees on shares sold prior to the compliance date of the rule and rule amendments, if they are adopted, and would continue to regulate the use of fund assets to pay for brokerage as under rule 12b-1(h) (by including a similar provision in proposed rule 12b-2). We have previously estimated that almost all funds (including small funds) that currently charge 25 basis points or less in asset-based distribution fees under rule 12b-1 would incur no additional reporting, recordkeeping, or compliance requirements under proposed rule 12b-2.

4. *Rule 11a-3*

As previously discussed, our proposal would amend rule 11a-3 to ensure that funds give credit for ongoing sales charges when an investor exchanges fund shares within a fund family. The proposed amendments would expand current recordkeeping responsibilities for funds that charge an ongoing sales charge, including small funds. Commission staff has estimated the costs of these changes for all funds in the cost-benefit analysis in Section V above. The staff estimates that 40 funds qualify as small entities for purposes of the Regulatory Flexibility Act, and that they would incur the same costs of compliance ($25,000, as estimated in section V.K above) to comply with the proposed amendments to rule 11a-3 as larger funds, because these funds use similar computer systems and/or transfer agents to track share exchanges. Although the volume of rule 11a-3 share exchanges may be less for small funds, with comparably lower costs of expanding the systems to handle exchanges as compared to larger funds, the staff estimates that any expenses incurred in upgrading these systems to meet the compliance requirements of our proposal would be comparable, due to a lack of bargaining power and economies of scale for the smaller funds. Therefore, the Commission staff estimates that each small fund family that charges 12b-1 fees high enough to qualify as ongoing sales charges, would incur $25,000 in expenses related to the proposed amendments to the reporting, recordkeeping, and compliance requirements of rule 11a-3.

5. Rules 17a-8, 17d-3, and 18f-3

Our proposal would make technical conforming changes to these rules as discussed in Section III.L above. Commission staff estimates that the proposed changes would create no change in the reporting, recordkeeping, or compliance requirements for funds (including small funds).

6. Form N-1A

Form N-1A is the form that open-end mutual funds use to register with the Commission. The proposed amendments would require funds that file Form N-1A to: (i) eliminate the line item currently titled "Distribution and/or service (12b-1) fee" and include two line items, (if relevant) titled "Marketing and Service Fee" and "Ongoing Sales Charge"; (ii) revise and streamline prospectus narrative disclosure on asset-based distribution fees; and (iii) revise and streamline SAI disclosure regarding asset-based distribution fees. The staff estimates that the proposed changes would reduce costs for all funds, including small entities, by reducing the amount of time and costs funds incur in preparing the forms, and would not impose new reporting or recordkeeping requirements.

7. Form N-3, Form N-4, and Form N-6

The proposed amendments to Forms N-3, N-4, and N-6 would conform disclosures in these forms to our proposals.[560] The proposed amendments would replace references to rule 12b-1 with references to proposed rules 6c-10(b) or 12b-2(b) and (d). Form N-3 is the

[560] Form N-3 is used by separate accounts offering variable annuity contracts and registered as management investment companies. Form N-4 is used by separate accounts offering variable annuity contracts and registered as unit investment trusts. Form N-6 is used by separate accounts offering variable life insurance contracts and registered as unit investment trusts.

registration form used by insurance company separate accounts registered as management investment companies that offer variable annuity contracts. The proposed amendments to Form N-3 would: (i) revise and streamline prospectus narrative disclosure on asset-based distribution fees; and (ii) revise and streamline Statement of Additional Information disclosure regarding asset-based distribution fees. The proposed changes would not impose new reporting or recordkeeping requirements for Form N-3.

The proposed changes to Forms N-4 and N-6 are technical and designed to update references to 12b-1 plans to the new terminology used in our proposal. These proposed changes would not change the reporting or recordkeeping requirements of these forms. In the cost-benefit analysis above, we explained that we do not anticipate that these amendments would result in new costs or burdens associated with preparing the forms. We do not believe that these amendments will impose any new recordkeeping, reporting, or compliance requirements.

8. Form N-SAR

Our proposal would amend the instructions to Form N-SAR, which currently requires funds to respond to a series of questions regarding their 12b-1 plans. Form N-SAR is the form that registered investment companies use to make periodic reports to the Commission. Our proposed amendments would add an instruction to Form N-SAR to disregard, for funds that no longer have 12b-1 plans, four questions (Items 41-44) that relate to the operation of rule 12b-1 plans (because they would be irrelevant in light of our proposed new framework for asset-based distribution fees). However, funds that maintain grandfathered fund classes would continue to respond to these items. The proposal would impose no new recordkeeping, reporting, or compliance requirements, and would instead reduce these burdens for respondents that do not have grandfathered 12b-1 plans.

9. Schedule 14A

Funds comply with the requirements of Schedule 14A when they solicit proxies from their shareholders. Our proposal would amend the required disclosures under section 14A when a fund institutes or materially increases a marketing and service fee after shares have been offered to the public. The proposed amendments would streamline proxy disclosures, removing items that would be superfluous if our proposed new rules and rule amendments on marketing and service fees were adopted. As discussed above, we have previously estimated that our changes to Schedule 14A would not create any new reporting, recordkeeping, or compliance burdens for funds that solicit proxies, and would instead reduce the existing burden.

10. Regulation S-X

Regulation S-X requires funds to file a statement of operations listing their income and expenses, and to state separately all amounts paid in accordance with a plan adopted under rule 12b-1. Our proposal would conform this requirement to the terms of our proposed new rules and rule amendments regarding asset-based distribution fees. The proposed amendments to regulation S-X would require that funds state asset-based distribution fees paid, and state separately amounts paid pursuant to our proposed rules on marketing and service fees and ongoing sales charges. Our understanding is that funds, as a matter of good business practice, already keep the information on asset-based distribution fees in the proper form, because that information is used to prepare information on 12b-1 fees, and is a component of the overall statement of expenses. The staff estimates that our proposed changes to regulation S-X would not change the amount of time or the costs required for funds (including small funds) to prepare their statements of operations. Therefore, we do not expect that these amendments will impose any new recordkeeping, reporting, or compliance requirements.

11. Rule 10b-10

Exchange Act rule 10b-10 requires broker-dealers to provide transaction confirmations to customers. The proposed amendments to this rule would require disclosure of additional information related to sales charges in connection with transactions involving mutual funds, and certain additional information in connection with callable debt securities. The proposed amendments would expand current recordkeeping responsibilities for broker-dealers, including small broker-dealers. As discussed above, the Commission staff estimates that the one-time burden for clearing firms with proprietary systems associated with these proposed amendments would equal total internal costs of approximately $180.7 million dollars[561] or approximately $1.1 million per clearing firm with a proprietary system.[562] Also as discussed above, as a general matter, medium-sized and smaller clearing firms, and also some larger ones, use platforms licensed from vendors to generate the data necessary to send confirmations. As discussed above, the staff understands that there are three primary vendors that license the majority of platforms to clearing firms that do not have proprietary systems. In addition, clearing firms may also use vendors to send physical confirmations to investors. Therefore, these vendors would have to reprogram their software and update these platforms to generate the data that would allow their clients to comply with these proposed amendments to rule 10b-10. Based on discussions with industry representatives, the staff is of the view that the cost and burdens to vendors to update the platforms that they license to clearing firms would be equivalent to the costs and burdens that would be incurred by clearing firms who would have to reprogram and update their proprietary

561 (4500 burden hours x 160 clearing firms with proprietary systems) x $251 dollars per hour = $180,720,000.

562 4500 hours x $251 dollars per hour = $1,129,500. *See* note 548 *supra*.

systems, resulting in a cost to these vendors of approximately $3.4 million dollars[563] or $1.1 million per vendor.[564] In addition, the staff understands that clearing firm licensees of these platforms would still incur a one-time cost of approximately $74.3 million dollars[565] or $200,800[566] per clearing firm licensee, to adopt the changes made to vendor platforms and to determine whether the output satisfies the requirements of the proposed amendments.

As discussed above, of the approximately 530 clearing firms that would incur upgrade costs, 17 of those are small entities. The staff believes that these small entity clearing firms would likely license their platforms from vendors. Accordingly, the staff estimates that these firms would incur costs of approximately $200,800 each to adapt to the changes in vendor platforms, or approximately $3.4 million total.[567] These figures are already included in the total burden costs that clearing firms, and in particular, clearing firm licensees, would incur to implement the proposed amendments to rule 10b-10.

In addition, as discussed above,[568] the staff believes that clearing firms will bear most of the costs associated with updating back-office operations to accommodate the proposed changes to rule 10b-10. Accordingly, the staff does not believe that small introducing firms will incur these costs.

12. *Request for Comment*

- The Commission solicits comment on these estimates and the anticipated effect the

563 (3 vendors x 4500 burden hours) x $251 dollars per hour = $3,388,500. *See* note 549 *supra*.

564 4500 hours x $251 dollars per hour = $1,129,500. *See* note 550 *supra*.

565 (800 burden hours x 370 clearing firms that use vendor licensed platforms) x $251 per hour = $74,296,000. *See* note 551 *supra*.

566 800 hours x $251 dollars per hour = $200,800. *See* note 552 *supra*.

567 (800 burden hours x 17 small entity clearing firms) x $251 per hour = $3,413,600.

568 *See* Section IV.H *supra*.

proposed amendments would have on small entities subject to the proposed rule and rule and form amendments.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We have not identified any federal rules that duplicate, overlap, or conflict with the proposed rule or rule or form amendments.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small issuers. In connection with the proposed amendments, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed amendments for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed amendments, or any part thereof, for small entities.

Investors in small funds face the same issues as investors in larger funds when paying asset-based distribution fees. Small funds use asset-based distribution fees as a means of growing their funds and accessing alternate distribution channels, and our rule proposal is designed to allow funds to continue to use asset-based distribution fees for these purposes. We have endeavored through the proposed amendments to minimize the regulatory burden on all funds, including small entities, while meeting our regulatory objectives. We have tried to design our proposal so that small entities would not be disadvantaged, and we anticipate that the potential impact of the proposed rule and amendments on small entities would not be significant.

Small entities should experience the same benefits from the proposal as other funds. We have endeavored to clarify, consolidate, and simplify disclosure for all funds, which should be beneficial for all funds, including those that are small entities. Moreover, with respect to the proposed revisions to the broker-dealer confirmation requirements of rule 10b-10, we also believe that special compliance or reporting requirements for small broker-dealers would not be appropriate or consistent with investor protection, because distinguishing such requirements based on the size of the broker-dealer may be accompanied by disparate treatment of investors and could lead to investor confusion.

For these reasons, we have not proposed alternatives to the proposed rule and rule and form amendments.

G. Request for Comments

We encourage the submission of comments with respect to any aspect of the IRFA.

- We particularly request comments on the number of, and the likely impact on, small entities that would be subject to the proposed rule, and rule and form amendments. Commenters are asked to describe the nature of any impact and provide empirical data supporting its extent. These comments will be considered in connection with any adoption of the proposed rule and amendments, and reflected in a Final Regulatory Flexibility Analysis.

Comments should be submitted in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Comments also may be submitted electronically to the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-15-10, and this file number should be included on the subject line if e-mail is used.[569] Comment letters will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549-1520, on official business days between the hours of 10:00 am and 3:00 pm. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (http://www.sec.gov).

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

Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition, and 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.[570] Section 2(b) of the Securities Act and section 3(f) of the Exchange Act require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[571] Further, section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[572] As discussed below, we expect that the proposed rule, and rule and form amendments, may promote efficiency, competition, and capital formation.

[569] Comments on the IRFA will be placed in the same public file that contains comments on the proposed rule and amendments.

[570] 15 U.S.C. 78w(a)(2).

[571] 15 U.S.C. 77b(b); 15 U.S.C. 78c(f).

[572] 15 U.S.C. 80a-2(c).

A. Removal of Rule 12b-1

Our proposal would remove rule 12b-1, and in so doing, would eliminate the explicit requirements in the rule for board approval and annual review of asset-based distribution fees and written 12b-1 plans. By eliminating these formal requirements in rule 12b-1, our proposal is designed to modify the regulations governing these fees to reflect current economic realities. As discussed in Section V above, funds may realize significant time and expense savings when managing asset-based distribution fees under our proposal, compared to the current requirements of rule 12b-1. Thus, we expect that the proposed removal of rule 12b-1 would enhance the efficiency of funds in managing and overseeing the operation and use of asset-based distribution fees.

Many funds use asset-based distribution fees to pay for distribution costs in a cost-effective manner that allows them to compete with other investment products. We expect that, in combination with the rest of our proposal, our proposed removal of rule 12b-1, if adopted, would not prevent funds from continuing to access the competitive benefits of paying for distribution through asset-based fees. Small funds often use asset-based distribution fees as a means of building their funds and participating in distribution channels that they might not otherwise be able to access. We have designed our proposals to allow funds to continue to grow through these means. In addition, our proposal would allow funds that currently charge 12b-1 fees to continue to deduct these fees on outstanding shares without significant disruption. Therefore, we do not anticipate that our proposal to remove rule 12b-1 would affect capital formation or competition.

B. Rule 12b-2

We are proposing to adopt rule 12b-2 (in combination with the rest of our proposal) to replace rule 12b-1. Proposed rule 12b-2 would allow funds to deduct a "marketing and service fee" from fund assets, up to the amount permitted for service fees under NASD Conduct Rule 2830. The proposed amendments would consider any asset-based distribution fee that exceeds this amount to be an "ongoing sales charge" that would be separately regulated under our proposed amendments to rule 6c-10, as discussed below. Proposed rule 12b-2 would not require a "plan" or impose other special board requirements to deduct a marketing and service fee. As discussed above, we expect that the marketing and service fee under proposed rule 12b-2 would allow funds to continue to experience the competitive and capital formation benefits resulting from a 25 basis point asset-based distribution fee. The limited conditions associated with the proposed rule should allow funds to impose these fees in a more efficient way. Because all funds would be able to rely on the proposed rule, and because we do not expect that the rule would affect the ability of funds to create distribution structures that fit their competitive model, we do not believe that the proposed rulemaking would impact competition significantly. We also do not anticipate that the proposed rule would significantly encourage or discourage assets being invested in the capital markets, or in particular funds, and thus do not expect that there would be a significant impact on capital formation.

C. Amended Rule 6c-10

Proposed rule 6c-10(b) would treat asset-based distribution fees deducted in excess of the marketing and service fee as "ongoing sales charges." The proposal would require that funds convert shares subject to an ongoing sales charge to a share class without the fee after the investor has paid cumulative amounts or rates of ongoing sales charges that equal the fund's front-end load.

We expect that the ongoing sales charge may allow investors to better understand the costs of distribution they pay, and would reduce the potential for some long-time investors to subsidize the distribution costs of other investors in the same fund. Our proposal therefore may allow investors who are better informed to allocate their investments more efficiently. The proposed amendments should also reduce fund intermediary conflicts of interest when advising investors regarding fund classes that provide different levels of intermediary compensation based on the period or method for payment of distribution fees. This might allow fund intermediaries to spend less time managing these conflicts and instead allocate their resources more efficiently towards providing better services to investors and increasing competition among intermediaries. Because all funds would be able to rely on the proposed rule, and because we do not expect that the rule would affect the ability of funds to create distribution structures that fit their competitive model, we do not believe that the proposed rulemaking would impact competition significantly. We also do not anticipate that the proposed rule would significantly encourage or discourage assets being invested in the capital markets, or in particular funds, and thus do not expect that there would be a significant impact on capital formation.

In addition, the proposed amendments to rule 6c-10(c) would permit funds to sell their shares at a price other than a current public offering price as described in the prospectus, which is otherwise required by section 22(d). Section 22(d) imposes a significant restriction on competition and the efficient setting of sales loads for mutual fund distribution, because it effectively requires dealers to sell fund shares at the same sales load, regardless of the services provided or the actual cost of distribution. Currently, all investors in a particular fund class pay the same costs for distribution when purchasing shares through a fund intermediary, regardless of the quality or type of services provided by the intermediary. Our proposal would allow funds to make available a class of shares that "unbundles" the costs of distribution from the fund's operating expenses. This is designed to give funds and intermediaries new avenues for competition, by permitting funds and intermediaries to break out the costs of distribution from other services they provide, and letting investors choose different levels of service based on their needs, considering among other things, cost and quality of the services offered.

Under our proposal, investors would be able to seek out intermediaries that provide a high level of service, provide simple execution of fund trades, or provide services that fall somewhere in the middle. Sales charges would be transparent and could be imposed or deducted in a manner and at any time selected by the investor. We expect that this would enhance efficiency of capital allocation as well as competition among fund intermediaries by allowing investors to shop for the pricing structure that best suits the investor's needs and the marketing choices of the fund or intermediary.[573]

Funds that take advantage of the exemption would be able to effectively externalize the distribution of their shares, an approach that may encourage small funds and new entrants to the market that are eager to attract dealers that wish to sell shares based on their own fee schedules. It may also permit these funds to compete better by reducing their expense ratios (because it would eliminate, at least with respect to the particular class, ongoing sales charges), while still charging low or no front-end sales loads. In addition, innovative distribution models may encourage additional investors to invest in the capital markets, enhancing capital formation.

An externalized approach could simplify the operations of intermediaries, allowing them to process transactions more efficiently based on a single, uniform fee structure. In some cases,

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573 Some roundtable commenters agreed that the externalization of asset-based distribution fees could improve competition among mutual funds. *See* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007) ("Mutualization of [12b-1] fees … distorts fundamental, free-market economics and restricts valuable competition in the intermediary channel.").

it could also simplify fund operations and fund prospectuses by eliminating the need to offer multiple classes of shares, further reducing fund expenses, enhancing the efficiency of distribution, and reducing investor confusion. This type of structure may also help traditional mutual funds better compete with other investments, such as exchange-traded funds (ETFs), which have externalized distribution costs and have been growing in popularity.[574]

The proposed exemption is designed to foster price competition among fund intermediaries that charge for the sale of mutual funds, and enhance the efficiency of fund operations and investor choice. Therefore, as discussed above, we expect that the proposed rule amendments are likely to enhance efficiency, competition, and capital formation in the fund marketplace.

D. Disclosure Amendments

Our proposal would amend Forms N-1A, N-SAR, N-3, N-4, and N-6 and Regulation S-X, to conform them to our proposed treatment of asset-based distribution fees.[575] The proposed amendments would improve disclosure by separately identifying the "marketing and service fee" and "ongoing sales charge" as individual line items in the fee table and income statement. The proposed amendments would also streamline current disclosure regarding asset-based distribution fees by replacing disclosure made irrelevant by our proposal with more narrowly focused and precise information regarding asset-based distribution fees. The proposed disclosure amendments would also replace references to 12b-1 fees in these forms with references to the appropriate rule in our proposal.

These proposed changes may allow investors to more efficiently obtain and manage

[574] In 2009, ETF assets grew 46 percent (from $531 billion to $777 billion) while traditional equity and bond mutual fund assets grew 16 percent (from $9.6 trillion to $11.1 trillion). *See* 2010 ICI Fact Book, *supra* note 6, at 9 and 41.

[575] *See supra* Section III.

information about their investments, as well as reduce the time and cost burdens funds bear in preparing this information. These proposed amendments may lead to increased efficiency by enhancing the ability of investors to more specifically identify the costs of distribution they pay when investing in funds. This information should promote more efficient allocation of investments by investors among funds because they may compare and choose funds based on their costs of distribution and the services provided for these fees more easily. To the extent that these create efficiencies, this may result in new investors investing in funds (or existing investors adding additional capital), and could enhance capital formation, and the efficiency of investors selecting among funds. Because these disclosure amendments would apply to all funds, we do not expect that they would have an impact on competition in the fund marketplace.

E. Rule 11a-3 and Technical Amendments

Our proposal would also make amendments to rule 11a-3 (which governs the payment of sales loads when making share exchanges within a fund family) to conform to our proposed treatment of asset-based distribution fees as sales loads. The proposed amendments would require funds to credit ongoing sales charges an investor has paid against any other load owed when the investor exchanges shares within a fund family. We do not anticipate that these amendments would affect capital formation or competition, nor would they reduce the efficiency of these exchanges because they apply to all funds and should not encourage or discourage investors to invest in the capital markets. We expect that the proposed amendments may reassure investors that they would not pay excessive distribution costs when making exchanges within a fund family, regardless of whether they chose to pay the costs of distribution front-end, over time, or upon redemption.

Our proposal would also make technical conforming amendments to rules 17a-8, 17d-3, and 18f-3, to replace references to rule 12b-1 with references to the appropriate rule regulating asset-based distribution fees in our proposal. We do not expect that these changes would affect the operation of funds, or the behavior of investors, fund intermediaries, or service providers. Therefore, we do not anticipate that these proposed amendments would impact competition, efficiency, or capital formation.

F. Rule 10b-10 Amendments

Our proposal further would amend rule 10b-10 to provide broker-dealer customers with improved information in transaction confirmations about mutual fund sales charges and about information regarding callable securities. These proposed amendments may lead to increased efficiency and competitiveness by enhancing the ability of investors to more specifically understand information related to their transactions in these securities, which not only would allow them to correct any associated errors, but also would help inform their future purchases of securities of this type and promote investment into securities that bear lower distribution-related costs.

G. Request for Comment

- We request comment on whether the proposed rule and rule and form amendments, if adopted, would promote efficiency, competition, and capital formation. We also request comment on any anti-competitive effects of the proposed amendments. Commenters are requested to provide empirical data and other factual support for their views, if possible.

VIII. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"), a rule is "major" if it results or is likely to result in:

- an annual effect on the economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

- We request comment on the potential impact of the proposed rules and rule amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

IX. STATUTORY AUTHORITY

The Commission is proposing amendments to rule 6-07 of Regulation S-X under the authority set forth in section 7 of the Securities Act [15 U.S.C. 77g] and sections 8 and 38(a) of the Investment Company Act [15 U.S.C. 80a-8 and 80a-37(a)]. The Commission is proposing amendments to Schedule 14A under the authority set forth in sections 3(b), 10, 13, 14, 15, 23(a), and 36 of the Securities Exchange Act [15 U.S.C. 78c(b), 78j, 78m, 78n, 78o, 78w(a), and 78mm], and sections 20(a), 30(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-20(a), 80a-29(a), and 80a-37(a)].

The Commission is proposing to rescind rule 12b-1 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing new rule 12b-2 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing amendments to rule 6c-10 under the authority set forth in sections 6(c), 12(b), 22(d)(iii), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(b), 80a-22(d)(iii), and 80a-37(a)]. The Commission is proposing amendments to rules 11a-3, 17a-8, 17d-3, and 18f-3 under the authority set forth in sections 6(c), 11(a), 17(d), 18(i), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-11(a), 80a-17(d), 80a-18(i), and 80a-37(a)]. The Commission is proposing amendments to Exchange Act rule 10b-10 pursuant to the authority conferred by the Exchange Act, including Sections 10, 17, 23(a), and 36(a)(1) [15 U.S.C. 78j, 78q, 78w(a), and 78mm(a)(1)].

The Commission is proposing amendments to registration Forms N-1A, N-3, N-4, and N-6 under the authority set forth in sections 6, 7(a), 10, and 19(a) of the Securities Act [15 U.S.C. 77f, 77g(a), 77j, and 77s(a)], and sections 8(b), 24(a), and 30 of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-24(a), and 80a-29]. The Commission is proposing amendments to Form N-SAR pursuant to authority set forth in sections 10(b), 13, 15(d), 23(a), and 36 of the Securities Exchange Act [15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm], and sections 8, 13(c), 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a-8, 80a-13(c), 80a-24(a), 80a-29, and 80a-37].

List of Subjects

17 CFR Part 210

Accounting, Reporting, and recordkeeping requirements, Securities.

17 CFR Parts 239, 240, and 249

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULES AND FORM AMENDMENTS

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

PART 210 – FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78(c), 78j-1, 78*l*, 78m, 78n, 78o(d), 78q, 78u-5, 78w, 78*ll*, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. The Part 210 heading is revised as set forth above.

3. Section 210.6-07 is amended by revising paragraph 2(f) to read as follows:

§ 210.6-07 Statements of operations.

* * * * *

2. *Expenses.* * * *

(f) State separately all fees deducted from fund assets to finance distribution activities pursuant to §§ 270.12b-2(b), (d) or 270.6c-10(b) of this chapter. Reimbursement to the fund of expenses deducted from fund assets pursuant to §§ 270.12b-2(b), (d) and 270.6c-10(b) shall be shown as a negative amount and deducted from current §§ 270.12b-2(b), (d) and 270.6c-10(b) expenses. If §§ 270.12b-2(b) and 270.6c-10(b) expense reimbursements exceed current §§ 270.12b-2(b) and 270.6c-10(b) expenses, such excess shall be used in the calculation of total expenses under this caption.

*   *   *   *   *

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

4. The authority citation for Part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78*l*, 78m, 78n, 78o(d), 78u-5, 78w(a), 78*ll*, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

*   *   *   *   *

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

5. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

6. Section 240.10b-10 is amended by:

a. Revising paragraph (a)(6)(i);

b. Revising paragraph (a)(9)(ii) by removing the period at the end of the paragraph and inserting "; and"

c. Adding paragraphs (a)(10) and (a)(11);

d. Revising paragraph (b)(2);

e. Adding paragraph (d)(10);

f. In paragraph (e) by removing ", *Provided* that:" at the end of the introductory text and adding in its place "; *provided* that the broker or dealer that effects any transaction for a customer in security futures products in a futures account gives or sends to the customer no later than the next business day after execution of any futures securities product transaction, written notification disclosing:"

g. Removing the introductory text of paragraph (e)(1) and redesignating paragraphs (e)(1)(i), (ii), (iii) and (iv) as paragraphs (e)(1), (2), (3), and (4); and

h. Removing paragraph (e)(2).

The revisions and additions read as follows.

§ 240.10b-10 Confirmation of transactions.

* * * * *

(a) * * *

(6) * * *

(i) The yield at which the transaction was effected, including the percentage amount and its characterization (e.g., current yield, yield to maturity, or yield to call) and if effected at yield to call, the type of call, the call date and, if different, the first date upon which the security may be called, and call price; and

* * * * *

(10) In the case of a purchase of a mutual fund security:

(i) The amount of any sales charge that the customer incurred at the time of purchase, expressed in dollars and as a percentage of the public offering price, the net dollar amount invested in the security, and the amount of any applicable breakpoint or similar threshold used to calculate the sales charge;

(ii) The maximum amount of any deferred sales charge that the customer may incur in connection with the subsequent redemption or sale of the securities purchased, expressed as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable;

(iii) If the customer will incur any ongoing sales charge (as defined in § 270.6c-10) or any marketing and service fee (as defined in § 270.12b-2) after the time of purchase:

(A) The annual amount of the charge or fee, expressed as a percentage of net asset value; the aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the customer will incur ongoing sales charge; and

(B) The following statement (which may be revised to reflect the particular charge or fee at issue): "In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you."; and

(11) In the case of a redemption or sale of a mutual fund security, the amount of any deferred sales charge that the customer has paid in connection with the redemption or sale, expressed in dollars and as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.

* * * * *

(b) * * *

(2) Such broker or dealer gives or sends to such customer within five business days after the end of each quarterly period, for transactions involving investment company and periodic plans, and after the end of each monthly period, for other transactions described in paragraph (b)(1) of this section, a written statement disclosing each purchase or redemption, effected for or with, and each dividend or distribution credited to or reinvested for, the account of such customer during the month; the date of such transaction; the identity, number, and price of any securities purchased or redeemed by such customer in each such transaction; the total number of shares of such securities in such customer's account; any remuneration received or to be received by the broker or dealer in connection therewith; any ongoing sales charges or marketing and service fees incurred in connection with the purchase or redemption of a mutual fund security; and that any other information required by paragraph (a) of this section will be furnished upon written request: *Provided*, *however*, that the written statement may be delivered to some other person designated by the customer for distribution to the customer; and

* * * * *

(d) * * *

(10) *Mutual fund security* means any security issued by an open-end company, as defined by section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1)), that is registered or required to register under section 8 of that Act, including any series of such company.

* * * * *

7. Schedule 14A (referenced in § 240.14a-101) is amended by revising paragraphs (a)(1)(iii) and (d) in Item 22 to read as follows:

§ 240.14a-101 Schedule 14A Information required in a proxy statement.

* * * * *

Item 22. Information required in investment company proxy statement.

(a) General.

(1) Definitions. * * *

(iii) *Marketing and Service Fee*. The term "Marketing and Service Fee" shall mean a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b) (§ 270.12b-2(b)).

* * * * *

(d) *Marketing and Service Fees*. If action is to be taken to institute a Marketing and Service Fee or increase the rate of an existing Marketing and Service Fee, include the following information in the proxy statement:

(1) A description of the nature of the action to be taken and the reasons therefore, the rate of the Marketing and Service Fee as it is proposed to be deducted and the purposes for which such fee may be used, and, if the action to be taken is an increase in the rate of an existing Marketing and Service Fee, the reasons for the increase.

(2) If the Fund currently deducts a Marketing and Service Fee:

(i) Provide the date that the Marketing and Service Fee was first instituted and the date of the last increase, if any;

(ii) Disclose the rate of the Marketing and Service Fee and the purposes for which such fee may be used; and

(iii) Disclose the name of, and the amount of any Marketing and Service Fee paid by the Fund during its most recent fiscal year to, any person who is an affiliated person of the Fund, its investment adviser, principal underwriter, or Administrator, an affiliated person of such person, or a person that during the most recent fiscal year received 10% or more of the aggregate amount of Marketing and Service Fees paid by the Fund.

*   *   *   *   *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

8. The authority citation for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a *et seq.* and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

*   *   *   *   *

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

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

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

10. The authority citation for § 270.6c-10 is revised to read as follows:

*   *   *   *   *

Section 270.6c-10 is also issued under 15 U.S.C. 80a-6(c), 15 U.S.C. 80a-12(b), 15 U.S.C. 80a-22(d) and 80a-37(a).

*   *   *   *   *

11. The authority citation for § 270.12b-2 is added to read as follows:

Authority: * * *

* * * * *

Section 270.12b-2 is also issued under 15 U.S.C. 80a-6(c), 15 U.S.C. 80a-12(b), and 80a-37(a).

* * * * *

12. The authority citation for § 270.17a-8 continues to read as follows:

Authority: * * *

* * * * *

Section 270.17a-8 is also issued under 15 U.S.C. 80a-6(c) and 80a-37(a).

* * * * *

13. Section 270.6c-10 is revised to read as follows:

§ 270.6c-10 Exemptions for certain open-end management investment companies to impose deferred sales loads and other sales charges.

(a) *Deferred Sales Load.*

(1) *Exemption.* Notwithstanding sections 2(a)(32), 2(a)(35), and 22(d) of the Act [15 U.S.C. 80a-2(a)(32), 80a-2(a)(35), and 80a-22(d), respectively] and § 270.22c-1, a fund, other than a registered separate account, and any exempted person may impose a deferred sales load on fund shares, if:

(i) The amount of the deferred sales load does not exceed a specified percentage of the net asset value or the offering price at the time of purchase; and

(ii) The terms of the deferred sales load are covered by the provisions of Rule 2830 of the Conduct Rules of the NASD; and

(iii) The same deferred sales load is imposed on all shareholders, except that a fund may offer scheduled variations in or elimination of a deferred sales load to a particular class of shareholders or transactions if the fund has satisfied the conditions in § 270.22d-1.

(2) *Load Reductions.* Nothing in this paragraph (a) prevents a fund from offering to existing shareholders a new scheduled variation that would waive or reduce the amount of a deferred sales load not yet paid.

(b) *Fund-Level Sales Charge.*

(1) *Exemption.* Notwithstanding § 270.12b-2(b)(1), a fund may deduct an ongoing sales charge from fund assets if the cumulative ongoing sales charges imposed on a purchase of fund shares do not exceed the shareholder's maximum sales load, provided that:

(i) A fund may satisfy the requirements of this paragraph (b) if shares subject to an ongoing sales charge convert (without any shareholder action and in accordance with § 270.18f-3(f)(2)) to a fund share class without an ongoing sales charge, on or before the end of the conversion period;

(ii) Shares acquired by reinvestment of dividends or other distributions may be invested in a fund share class with an ongoing sales charge only if the reinvested shares convert to a share class without an ongoing sales charge no later than when the shares on which the dividend or distribution was declared convert;

(iii) A fund may offer scheduled variations in the conversion period to a particular class of shareholders or transactions if the fund has satisfied the conditions in § 270.22d-1; and

(iv) The fund does not acquire shares of another fund that, with respect to the class of shares acquired, deducts an ongoing sales charge.

(2) *Sales Charge Reductions.* Nothing in this paragraph (b) prevents a fund from

offering to existing shareholders a new scheduled variation that would reduce the conversion period.

(3) *Changes to Ongoing Sales Charge*. No fund may:

(i) Institute or increase the rate of an ongoing sales charge applied to a fund share class or series after any public offering of the fund's voting shares or the sale of such shares to persons who are not organizers of the fund; or

(ii) Increase the amount of time after which a share class will automatically convert to a class of shares that does not have an ongoing sales charge, if it would increase the cumulative amount of ongoing sales charges imposed.

(c) *Account-Level Sales Charge*. Notwithstanding section 22(d) of the Act [15 U.S.C. 80a-22(d)], any fund class and any exempted person may offer or sell fund shares at a price other than the current public offering price described in the prospectus, if:

(1) The class does not impose an ongoing sales charge pursuant to § 270.6c-10(b), although it may impose a marketing and service fee pursuant to § 270.12b-2(b); and

(2) The fund discloses in its registration statement that it has elected to rely on this paragraph (c) for an exemption from section 22(d) of the Act [15 U.S.C. 80a-22(d)].

(d) *Definitions*. For purposes of this section:

(1) *Acquired security* has the same meaning as in § 270.11a-3(a)(1).

(2) *Conversion period* is the period beginning on the day that shares are purchased and ending on the last day of the calendar month during which the cumulative ongoing sales charge rates exceed the shareholder's maximum sales load rate. The maximum number of months in a conversion period is determined by dividing the shareholder's maximum sales load rate by the ongoing sales charge rate and multiplying the result by 12.

(3) *Deferred sales load* means any amount properly chargeable to sales or promotional expenses that is paid directly by a shareholder to a fund after purchase but before or upon redemption.

(4) *Distribution activity* means any "Distribution activity," as defined in § 270.12b-2(e)(2).

(5) *Exchanged security* has the same meaning as in § 270.11a-3(a)(4).

(6) *Exempted person* means any principal underwriter of, dealer in, and any other person authorized to effect transactions in, shares of a fund.

(7) *Fund* means a registered open-end management investment company, and includes a separate series of a fund.

(8) *Group of investment companies* has the same meaning as in § 270.11a-3(a)(5).

(9) *Maximum sales load* means the maximum sales load rate multiplied by the total dollar amount paid.

(10) *Maximum sales load rate* means the reference load minus the sum of the rates of:

(i) Any sales load (including a deferred sales load) incurred in connection with the purchase of fund shares; and

(ii) Any sales loads or ongoing sales charges previously paid with respect to an exchanged security within the same group of investment companies.

(11) *Ongoing sales charge* means any charges or fees deducted from fund assets to finance distribution activity in excess of the maximum rate permitted under § 270.12b-2(b). In the case of a fund ("the acquiring fund") that acquires shares of another fund (the "acquired fund"), ongoing sales charge means any charges or fees deducted from fund assets to finance distribution activity in excess of the acquiring fund's marketing and service fee (as defined in

§ 270.12b-2(e)(3)), without regard to any acquired fund's marketing and service fee.

(12) *Ongoing sales charge rate* is the annual ongoing sales charge, expressed as a percentage of net asset value.

(13) *Organizers of a fund* means any affiliated person of the fund, any affiliated person of such person, any promoter of the fund, and any affiliated person of such promoter.

(14) *Reference load* means:

(i) The highest sales load rate that the shareholder would have paid if, at the time of the purchase of fund shares, the shareholder had purchased a class offered by the fund that does not have an ongoing sales charge and for which the shareholder qualifies according to the fund's registration statement;

(ii) In the case of shares exchanged within the same group of investment companies, the highest applicable sales load rate of the acquired security or the exchanged security; or

(iii) If no reference load can be determined under paragraphs (d)(14)(i) or (d)(14)(ii) of this section, the reference load is the maximum sales charge rate permitted a fund that deducts an asset-based sales charge and a service fee under Rule 2830(d)(2)(A) of the Conduct Rules of the NASD.

(15) *Sales load rate* is the sales load expressed as a percentage of the fund share offering price.

14. Section 270.11a-3 is amended by revising paragraphs (b)(4) and (b)(5)(i)(A) and (b)(5)(ii)(A) to read as follows:

§ 270.11a-3 Offers of exchange by open-end investment companies other than separate accounts.

* * * * *

(b) * * *

(4) Any sales load charged with respect to the acquired security is a percentage that is no greater than the excess, if any, of the rate of the sales load applicable to that security in the absence of an exchange over the sum of the rates of all sales loads and ongoing sales charges (as permitted under § 270.6c-10(b)), previously paid on the exchanged security, *Provided that*:

(i) The percentage rate of any sales load charged when the acquired security is redeemed, that is solely the result of a deferred sales load imposed on the exchanged security, may be no greater than the excess, if any, of the applicable rate of such sales load, calculated in accordance with paragraph (b)(5) of this section, over the sum of the rates of all ongoing sales charges and sales loads previously paid on the acquired security, and

(ii) In no event may the sum of the rates of all ongoing sales charges and sales loads imposed prior to and at the time the acquired security is redeemed, including any ongoing sales charges and sales load paid or to be paid with respect to the exchanged security, exceed the maximum sales load rate, calculated in accordance with paragraph (b)(5) of this section, that would be applicable in the absence of an exchange to the security (exchanged or acquired) with the highest such rate;

(5) * * *

(i) * * *

(A) reduced by the sum of the rates of all ongoing sales charges collected on the acquired security pursuant to §270.6c-10(b), and

* * * * *

(ii) * * *

(A) the deferred sales load is reduced by the sum of the rates of all ongoing sales charges previously collected on the exchanged security pursuant to § 270.6c-10(b), and

* * * * *

15. Section 270.12b-1 is removed.

16. Section 270.12b-2 is added to read as follows:

§ 270.12b-2 Investment company distribution fees.

(a) *Preliminary Matters.*

(1) Except as provided in this section, it is unlawful for any fund (other than a fund complying with the provisions of section 10(d) of the Act [15 U.S.C. 80a-10(d)]) to act as a distributor of securities of which it is the issuer, except through an underwriter.

(2) For purposes of this section, a fund will be deemed to be acting as a distributor of securities of which it is the issuer, other than through an underwriter, if it directly or indirectly uses fund assets to finance any distribution activity.

(b) *Marketing and Service Fee.* A fund may use fund assets to finance distribution activity, provided that, with regard to any class of the fund:

(1) All charges and fees deducted from fund assets to finance distribution activity do not exceed the maximum rate of the service fee allowed under Rule 2830 of the NASD Conduct Rules, except as permitted by § 270.6c-10(b);

(2) If a fund (the "acquiring fund") acquires shares of another fund (the "acquired fund"), the combined rate of the marketing and service fees of the acquiring fund and any acquired fund to finance distribution activities does not exceed the maximum rate permitted in paragraph (b)(1) of this section.

(3) The marketing and service fee (or any increase in the rate of such a fee) has been approved by a vote of at least a majority of the fund's outstanding voting securities if the fee is instituted or increased after any public offering of the fund's voting securities or the sale of such securities to persons who are not affiliated persons of the company, affiliated persons of such persons, promoters of the fund, or affiliated persons of such promoters.

(c) *Directed Brokerage*. Notwithstanding any other provision of this section, a fund may not:

(1) Compensate a broker or dealer for any promotion or sale of shares issued by that fund by directing to the broker or dealer:

(i) The fund's portfolio securities transactions; or

(ii) Any remuneration, including but not limited to any commission, mark-up, mark-down, or other fee (or portion thereof) received or to be received from the fund's portfolio transactions effected through any other broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer); and

(2) Direct its portfolio securities transactions to a broker or dealer that promotes or sells shares issued by the fund, unless the fund (or its investment adviser):

(i) Is in compliance with the provisions of paragraph (c)(1) of this section with respect to that broker or dealer; and

(ii) Has implemented, and the fund's board of directors (including a majority of directors who are not interested persons of the fund) has approved, policies and procedures reasonably designed to prevent:

(A) The persons responsible for selecting brokers and dealers to effect the fund's portfolio securities transactions from taking into account the brokers' and dealers' promotion or sale of shares issued by the fund or any other registered investment company; and

(B) The fund, and any investment adviser and principal underwriter of the fund, from entering into any agreement (whether oral or written) or other understanding under which the fund directs, or is expected to direct, portfolio securities transactions, or any remuneration described in paragraph (c)(1)(ii) of this section, to a broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer) in consideration for the promotion or sale of shares issued by the fund or any other registered investment company.

(d) *Grandfathered Rule 12b-1 Fees.* Until [date 5 years after compliance date of the rule], notwithstanding any other provision in this section, a fund may act as a distributor of securities sold prior to [the compliance date of rule 12b-2] subject to a rule 12b-1 plan approved under § 270.12b-1 (2010 version) as in effect prior to [the compliance date of rule 12b-2], *provided that*:

(1) The fund's board of directors may vote to eliminate the provisions in the fund's rule 12b-1 plan that were required by paragraphs (b)(3)(i) (annual approval), (b)(3)(ii) (quarterly reports) and (b)(3)(iii) (termination) of § 270.12b-1 (2010 version);

(2) With regard to any class of the fund, the fund does not increase the annual rate of the fee paid under its rule 12b-1 plan in the most recent fiscal year, and

(3) As of [date 5 years after compliance date of the rule] all securities subject to paragraph (d) of this section must be exchanged or converted into securities of a class that does not deduct an ongoing sales charge as defined in § 270.6c-10(d)(11) and that does not charge a marketing and service fee in excess of the annual rate of the fee paid under its rule 12b-1 plan in the most recent fiscal year.

(e) *Definitions.* For purposes of this section:

(1) *Fund* means a registered open-end management investment company, and includes a separate series of the fund.

(2) *Distribution activity* means any activity which is primarily intended to result in the sale of shares issued by a fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature.

(3) *Marketing and Service Fee* means any charges or fees deducted from fund assets under paragraph (b)(1) of this section.

* * * * *

17. Section 270.17a-8 is amended by revising paragraph (a)(3)(iv) to read as follows:

§ 270.17a-8 Mergers of affiliated companies.

(a) * * *

(3) * * *

(iv) Any distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the surviving company pursuant to provisions of § 270.12b-2(b) or (d) or § 270.6c-10(b), are no greater than the distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the merging company.

18. Section 270.17d-3 is amended by revising paragraph (a) to read as follows:

§ 270.17d-3 Exemption relating to certain joint enterprises or arrangements concerning payment for distribution of shares of a registered open-end management investment company.

*   *   *   *   *

(a) Such agreement is made in compliance with the provisions of § 270.12b-2(b) or (d) or § 270.6c-10(b); and

*   *   *   *   *

19. Section 270.18f-3 is amended by revising paragraph (f)(2)(ii) to read as follows:

§ 270.18f-3 Multiple class companies.

*   *   *   *   *

(f)   *   *   *

(2)   *   *   *

(ii) The expenses, including distribution payments authorized under § 270.12b-2(b) or (d) or § 270.6c-10(b), for the target class are not higher than the expenses, including distribution payments authorized under § 270.12b-2(b) or (d) or § 270.6c-10(b), for the purchase class; and

*   *   *   *   *

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

20. The authority citation for Part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

*   *   *   *   *

21. Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

a. Adding the definition "asset-based distribution fee" in alphabetical order to

General Instructions A;

b. Revising the "Annual Fund Operating Expenses" fee table and Instruction 3(b) to Item 3;

c. Revising paragraph b and removing the Instruction to paragraph b of Item 12;

d. Revising paragraph g and adding an Instruction to paragraph g of Item 19;

e. Adding paragraph d to item 25;

f. Revising Instruction 5 to paragraph (b)(4) of Item 26;

g. In the expense example in paragraph (d)(1) of Item 27, removing the reference to "distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees";

h. In Instruction 2(a)(i) following paragraph (d)(1) to Item 27, removing the reference to "Distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees"; and

i. Removing and reserving paragraph (m) of Item 28.

The revisions read as follows:

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

Form N-1A

* * * * *

General Instructions

A. Definitions

* * * * *

"Asset-Based Distribution Fee" means a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b) (17 CFR § 270.12b-2(b)) ("Marketing and

Service Fee"), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and/or rule 6c-10(b) (17 CFR § 270.6c-10(b)) ("Ongoing Sales Charge").

*   *   *   *   *

Item 3. Risk/Return Summary: Fee Table

*   *   *   *   *

Annual Fund Operating Expenses (expenses that you pay each year as a percentage of the value of your investment)

Management Fees	____%
Ongoing Sales Charge	____%
Other Expenses	____%
Marketing and Service Fee	____%
	____%
	____%
Total Annual Fund Operating Expenses	____%

*   *   *   *   *

Instructions.

*   *   *   *   *

3. *Annual Fund Operating Expenses*

*   *   *   *   *

(b) "Ongoing Sales Charge" includes all expenses incurred during the most recent fiscal year pursuant to rule 6c-10(b) (17 CFR § 270.6c-10(b)). "Marketing and Service Fee" includes all expenses incurred during the most recent fiscal year pursuant to rule 12b-2(b) (17 CFR § 270.12b-2(b)).

* * * * *

Item 12. Distribution Arrangements

* * * * *

(b) *Asset-Based Distribution Fees.* If the Fund deducts an Asset-Based Distribution Fee, state separately the rate of Ongoing Sales Charges, Marketing and Service Fees, or fees charged pursuant to rule 12b-2(d) (17 CFR § 270.12b-2(d)), as applicable, and state each one's purpose and general terms, and provide disclosure to the following effect:

(1) The Fund deducts a fee for the sale and distribution of its shares and, if applicable, for services provided to fund investors. If the Fund deducts a fee for such services, describe the nature and extent of services provided to fund investors.

(2) For Multiple Class Funds that offer more than one Class in the prospectus, discuss the general circumstances under which an investment in a Class that deducts an Asset-Based Distribution Fee may be more or less advantageous than an investment in a Class that either does not deduct an Asset-Based Distribution Fee or a Class that deducts a different Asset-Based Distribution Fee. Include the effect of different holding periods and investment amounts in this description.

(3) For Funds that deduct an Ongoing Sales Charge, the number of months/years that an investor's shares would be subject to the charge before automatically converting to a Class without such a deduction.

* * * * *

Item 19. Investment Advisory and Other Services

* * * * *

(g) *Asset-Based Distribution Fees.* If the Fund deducts an Asset-Based Distribution Fee, provide a description of the fee(s) and how they are used, including a list of the principal types of activities for which payments are or will be made (*e.g.*, advertising; printing and mailing of prospectuses to other than current shareholders; compensation to underwriters, compensation to broker-dealers, shareholder servicing fees, *etc.*).

Instruction. If a Fund offers a Class that deducts both an Ongoing Sales Charge and a Marketing and Service Fee, separate the list of activities according to type of fee.

* * * * *

Item 25. Underwriters

* * * * *

(d) If the fund has elected to rely on rule 6c-10(c) (17 CFR § 270.6c-10(c)) to permit the fund or its underwriter to distribute shares at a price other than a current public offering price described in the prospectus, state that the fund has made this election.

* * * * *

Item 26. Calculation of Performance Data

* * * * *

(b) * * *

(4) * * *

Instructions.

* * * * *

5. Include expenses accrued due to any Asset-Based Distribution Fees owed in the expenses accrued for the period. Reimbursement accrued may reduce the accrued expenses, but only to the extent the reimbursement does not exceed expenses accrued for the period.

* * * * *

Item 28. Exhibits

* * * * *

(m) *Reserved.*

* * * * *

22. Form N-3 (referenced in §§ 239.17a and 274.11b) is amended by:

a. Revising Instruction 2 to Item 7(a);

b. Revising paragraph (f) and the Instruction to paragraph (f) of Item 21;

c. Revising Instruction 5 to Item 26(b)(ii).

The revisions read as follows:

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

Form N-3

* * * * *

Item 7. Deductions and Expenses

(a) * * *

Instructions:

* * * * *

2. If proceeds from explicit sales loads will not cover the expected costs of distributing the contracts, identify from what source the shortfall, if any, will be paid. If any shortfall is to be made up from assets from the Insurance Company's general account, disclose, if applicable, that any amounts paid by the Insurance Company may consist, among other things, of proceeds derived from mortality and expense risk charges deducted from the account. If Registrant directly or indirectly pays any asset-based distribution expenses under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), or rule 6c-10(b) (17 CFR § 270.6c-10(b)), provide a description of the expenses and list the principal types of activities for which payments are made.

* * * * *

Item 21. Investment Advisory and Other Services

* * * * *

(f) If the Registrant deducts any asset-based distribution fees under rule 12b-2(b) (§ 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), or rule 6c-10(b) (17 CFR § 270.6c-10(b)), provide a description of the fee(s) and how they are used, including a list of the principal types of activities for which payments are or will be made (*e.g.*, advertising; printing and mailing of prospectuses to other than current shareholders; compensation to underwriters, compensation to broker-dealers, shareholder servicing fees, *etc.*).

Instruction. If a Registrant deducts both an ongoing sales charge and a marketing and service fee, separate the list of activities according to type of fee.

*   *   *   *   *

Item 26. Calculation of Performance Data

*   *   *   *   *

(b)   *   *   *

(ii)   *   *   *

*   *   *   *   *

Instructions.

*   *   *   *   *

5. Include all asset-based distribution expenses accrued under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)) among the expenses accrued for the period. Reimbursement of expenses deducted from fund assets pursuant to rule12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)) may reduce the accrued expenses, but only to the extent the reimbursement does not exceed expenses accrued for the period.

*   *   *   *   *

23. Form N-4 (referenced in §§ 239.17b and 274.11c) is amended by:

a. In the "Total Annual [Portfolio Company] Operating Expenses" table in Item 3(a), removing the reference to "distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees."

b. In Instruction 16 to Item 3 adding a definition of "asset-based distribution fees."

The addition reads as follows:

Note: the text of Form N-4 does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-4

* * * * *

Item 3. Synopsis

* * * * *

16. "Management Fees" include investment advisory fees (including any component thereof based on the performance of the portfolio company), any other management fees payable by the portfolio company to the investment adviser or its affiliates, and administrative fees payable to the investment adviser or its affiliates not included as "Other Expenses." "Asset-based distribution fee" includes all asset-based distribution expenses paid under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)).

* * * * *

24. Form N-6 (referenced in §§ 239.17c and 274.11d) is amended by:

a. In the "Total Annual [Portfolio Company] Operating Expenses" table in Item 3, removing the reference to "distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees."

b. Adding paragraph (g) to Instruction 4 of Item 3.

The addition reads as follows:

Note: the text of Form N-6 do not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-6

* * * * *

Item 3. Risk/Benefit Summary: Fee Table

* * * * *

Instructions.

* * * * *

(4) * * *

(g) "Asset-based distribution fee" includes all asset-based distribution expenses paid under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)).

* * * * *

25. Form N-SAR (referenced in §§ 249.330 and 274.101) is amended by:

a. Revising Item 40 in Instructions to Specific Items;

b. Removing Items 41-44 in Instructions to Specific Items; and

c. Removing the last sentence in the Instruction to Sub-Item 72DD2 in Instructions to Specific Items.

The revision reads as follows:

Note: the text of Form N-6 do not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-SAR

* * * * *

Instructions to Specific Items

* * * * *

Item 40: Plans Adopted Pursuant to Former Rule 12b-1

Rule 12b-1 under the Act (17 CFR § 270.12b-1), has been rescinded. Registrants that have grandfathered 12b-1 share classes pursuant to rule 12b-2(d) (17 CFR § 270.12b-2(d)), should answer this question "Yes." Registrants that do not have grandfathered 12b-1 share classes pursuant to rule 12b-2(d) under the Act should answer this question "No."

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 21, 2010

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62537 / July 21, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13971

In the Matter of **Avalon Capital Holdings, Inc.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES 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 Avalon Capital Holdings, Inc. ("AVLC" or "Respondent").

II.

In anticipation of the institution of these proceedings, AVLC 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, AVLC consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), and to the findings as set forth below.

III.

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

1. AVLC (CIK No. 1103406) is a Delaware corporation located in Beverly Hills, California with a class of securities registered with the Commission

under Exchange Act Section 12. As of March 11, 2010, the common stock of AVLC (symbol "AVLC") was quoted on the Pink Sheets operated by Pink OTC Markets Inc., had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. AVLC has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder while its securities were registered with the Commission in that it has not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2004.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of AVLC's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

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. 62535 / July 21, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13969

In the Matter of **Image Innovations Holdings, Inc.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES 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 Image Innovations Holdings, Inc. ("IMGVQ" or "Respondent").

II.

In anticipation of the institution of these proceedings, IMGVQ 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, IMGVQ consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), and to the findings as set forth below.

III.

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

1. IMGVQ (CIK No. 1063842) is a Nevada corporation located in Orangeburg, New York with a class of securities registered with the Commission

under Exchange Act Section 12. As of March 12, 2010, the common stock of IMGVQ (symbol "IMGVQ") was quoted on the Pink Sheets operated by Pink OTC Markets Inc. The Respondent filed a Chapter 11 bankruptcy proceeding on July 6, 2006, which was terminated on March 10, 2010.

2. IMGVQ has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 30, 2005.

IV.

Section 12(j) of the Exchange Act provides as follows:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of IMGVQ's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

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. 62536 / July 21, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13970

In the Matter of **Diamond Equities, Inc.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES 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 Diamond Equities, Inc. ("DDEQ" or "Respondent").

II.

In anticipation of the institution of these proceedings, DDEQ 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, DDEQ consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), and to the findings as set forth below.

III.

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

1. DDEQ (CIK No. 923150) is a Nevada corporation located in McKinney, Texas with a class of securities registered with the Commission under

Exchange Act Section 12. As of March 22, 2010, the common strock of DDEQ (symbol "DDEQ") was traded on the over-the-counter markets.

2. DDEQ has failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 30, 2001.

IV.

Section 12(j) of the Exchange Act provides as follows:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of DDEQ's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Casey and Commissioner Paredes Disapproved

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC-29366; 812-13796]

Goldman, Sachs & Co., et al.; Notice of Application and Temporary Order

July 21, 2010

Agency: Securities and Exchange Commission ("Commission").

Action: Temporary order and notice of application for a permanent order under section 9(c) of the Investment Company Act of 1940 ("Act").

Summary of Application: Applicants have received a temporary order exempting them from section 9(a) of the Act, with respect to an injunction entered against Goldman, Sachs & Co. ("Goldman Sachs") on July 20, 2010 by the United States District Court for the Southern District of New York (the "Injunction"), until the Commission takes final action on an application for a permanent order. Applicants also have applied for a permanent order.

Applicants: Goldman Sachs, Goldman Sachs Asset Management, L.P. ("GSAM, L.P."), Goldman Sachs Asset Management International ("GSAMI"), Goldman Sachs Hedge Fund Strategies LLC ("GSHFS"), Commonwealth Annuity and Life Insurance Company ("Commonwealth"), First Allmerica Financial Life Insurance Company ("FAFLIC") and Epoch Securities, Inc. ("Epoch," together, the "Applicants").[1]

Filing Dates: The application was filed on July 16, 2010, and amended on July 21, 2010.

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[1] Applicants request that any relief granted pursuant to the application also apply to any existing company of which Goldman Sachs is an affiliated person and to any other company of which Goldman Sachs may become an affiliated person in the future (together with Applicants, "Covered Persons").

Hearing or Notification of Hearing: An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving Applicants with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on August 16, 2010, and should be accompanied by proof of service on Applicants, in the form of an affidavit, or for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities & Exchange Commission, 100 F Street NE, Washington, DC 20549-1090. Applicants: Goldman Sachs, GSAM, L.P. and GSHFS, 200 West Street, New York, NY 10282; GSAMI, Christchurch Court, 10-15 Newgate Street, London, England EC1A7HD; and Commonwealth, FAFLIC and Epoch, 132 Turnpike Road, Southborough, MA 01772.

For Further Information, Contact: Jaea F. Hahn, Senior Counsel, at (202) 551-6870 or Janet M. Grossnickle, Assistant Director, at 202-551-6821 (Division of Investment Management, Office of Investment Company Regulation).

Supplementary Information: The following is a temporary order and a summary of the application. The complete application may be obtained via the Commission's Web site by searching for the file number, or an applicant using the Company name box, at http://www.sec.gov/search/search.htm, or by calling (202) 551-8090.

Applicants' Representations:

1. Goldman Sachs, a New York limited partnership, is a global investment banking and securities firm. Goldman Sachs is registered as an investment adviser with the Commission pursuant to section 203 of the Investment Advisers Act of 1940 ("Advisers Act"). Goldman Sachs is also registered as a broker-dealer under the Securities Exchange Act of 1934 (the "Exchange Act") and acts as a principal underwriter of certain registered investment companies. GSAM, L.P, GSAMI and GSHFS are each registered under the Advisers Act as investment advisors and provide investment advisory or subadvisory services to Funds.[2] Commonwealth and FAFLIC are insurance companies domiciled in Massachusetts and each acts as depositor for certain separate accounts that are registered as UITs under the Act. Epoch is a registered broker-dealer that acts as principal underwriter for the UITs of Commonwealth and FAFLIC. Each of Goldman Sachs, GSAM, L.P., GSAMI and GSHFS provide investment advisory services to ESCs, as defined in section 2(a)(13) of the Act, which provide investment opportunities for partners of Goldman Sachs (prior to its initial public offering) and certain employees and consultants of Goldman Sachs and its affiliates. GSHFS does not currently provide investment advisory services to registered investment companies.

2. On July 20, 2010, the United States District Court for the Southern District of New York entered a final judgment, which included the Injunction against

[2] "Funds" refer to any registered investment company or employees' securities company ("ESC") for which a Covered Person serves as an investment adviser, subadviser or depositor, or any registered open-end investment company, registered unit investment trust ("UIT") or registered face amount certificate company for which a Covered Person serves as principal underwriter (such activities, collectively, "Fund Servicing Activities").

Goldman Sachs in a matter brought by the Commission ("Final Judgment").[3] The Commission alleged in the complaint ("Complaint") that offering materials related to a transaction in which in which Goldman Sachs or its affiliates sold synthetic collateralized debt obligations, which referenced a portfolio of synthetic mortgage-backed securities, to two institutional investors in early 2007 ("Transaction"), should have disclosed that the hedge fund assuming the short side of the Transaction had played a role in the selection process. As part of an agreement to settle the action, Goldman Sachs entered into a consent in which it acknowledged that it was a mistake not to disclose the role of the hedge fund in the Transaction and consented to the entry of the Final Judgment, including the Injunction. The Final Judgment will also decree that Goldman Sachs is liable for disgorgement of $15 million and a civil penalty of $535 million.[4]

Applicants' Legal Analysis:

1. Section 9(a)(2) of the Act, in relevant part, prohibits a person who has been enjoined from engaging in or continuing any conduct or practice in connection with the purchase or sale of a security from acting, among other things, as an

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3 Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre, 10-CV-03229 (S.D.N.Y. July 20, 2010).

4 The Final Judgment will also require Goldman Sachs to comply with certain undertakings relating to (i) the vetting and approval process for offerings of residential mortgage-related securities products by its firmwide Capital Committee, (ii) review of marketing materials used in connection with residential mortgage-related securities offerings by Goldman Sachs' Legal Department and Compliance Department, (iii) annual internal audits of the review of such marketing materials, (iv) where Goldman Sachs is the lead underwriter of an offering of residential mortgage-related securities and retains outside counsel to advise on the offering, review of the related offering materials by outside counsel and (v) education and training of persons involved in the structuring or marketing of residential mortgage-related securities offerings.

investment adviser or depositor of any registered investment company or a principal underwriter for any registered open-end investment company, registered UITs or registered face-amount certificate company. Section 9(a)(3) of the Act makes the prohibition in section 9(a)(2) applicable to a company any affiliated person of which has been disqualified under the provisions of section 9(a)(2). Section 2(a)(3) of the Act defines "affiliated person" to include any person directly or indirectly controlling, controlled by, or under common control with, the other person. Applicants state that Goldman Sachs is an affiliated person of each of the other Applicants within the meaning of section 2(a)(3) of the Act because they are under common control. Applicants state that entry of the Final Judgment would result in the disqualification of Goldman Sachs under section 9(a)(2) and the other Applicants under section 9(a)(3) of the Act.

2. Section 9(c) of the Act provides that the Commission shall grant an application for exemption from the disqualification provisions of section 9(a) if it is established that these provisions, as applied to Applicants, are unduly or disproportionately severe or that Applicants' conduct has been such as not to make it against the public interest or the protection of investors to grant the application. Applicants have filed an application pursuant to section 9(c) seeking a temporary and permanent order exempting them from the disqualification provisions of section 9(a) of the Act.

3. Applicants believe they meet the standards for exemption specified in section 9(c). Applicants state that the prohibitions of section 9(a) as applied to them would be unduly and disproportionately severe and that the conduct of Applicants has

been such as not to make it against the public interest or the protection of investors to grant the exemption from section 9(a).

4. Applicants state that the violations alleged in the Complaint did not involve Fund Servicing Activities or the current or former Goldman Sachs employees who are or were involved in Fund Servicing Activities. Applicants also state that no current or former director, officer, or employee of Goldman Sachs or the other Applicants—who is involved in providing Fund Servicing Activities to Funds—had any knowledge of, or was involved in, the conduct that forms the basis of the Complaint. Applicants further state that the individual defendant named in the Complaint and the other personnel at Goldman Sachs who were involved in the violations alleged in the Complaint have had no and will not have any future involvement in providing Fund Servicing Activities to Funds. Applicants represent that the alleged conduct giving rise to the Final Judgment did not involve any Fund or the assets of any Fund for which an Applicant provided Fund Servicing Activities.

5. Applicants state that the inability of the Applicants to engage in Fund Servicing Activities would result in potentially severe hardships for the Funds (including the UITs) and their shareholders or contract holders. Applicants state that they will distribute, as soon as reasonably practicable, written materials, including an offer to meet in person to discuss the materials, to the boards of directors or trustees of the Funds (excluding for this purpose, the ESCs) (the "Boards"), including the directors who are not "interested persons," as defined in section 2(a)(19) of the Act, of such Funds and their independent legal counsel, as defined in rule 0-1(a)(6) under the Act, if any, regarding the Injunction, any impact on the Funds, and the application.

Applicants have provided and will continue to provide the Funds with all information concerning the Final Judgment and the application that is necessary for the Funds to fulfill their disclosure and other obligations under the federal securities laws.

6. Applicants also assert that, if they were barred from providing Fund Servicing Activities to the Funds and ESCs, the effect on their businesses and employees would be severe. Applicants state that they have committed substantial resources to establish an expertise in Fund Servicing Activities. Applicants further state that prohibiting them from Fund Servicing Activities would not only adversely affect their businesses, but would also adversely affect over 600 employees at GSAM, L.P. alone that are involved in those activities. Applicants also state that disqualifying Goldman Sachs, GSAM, L.P., GSAMI and GSHFS from continuing to provide investment advisory services to ESCs is not in the public interest or in furtherance of the protection of investors. Applicants assert that it would not be consistent with the purposes of the ESC provisions of the Act or the representations made in the application for the ESC order to require another entity not affiliated with Goldman Sachs to manage the ESCs. In addition, participants in the ESCs have subscribed for interests in the ESCs with the expectation that the ESCs would be managed by Goldman Sachs or one of its affiliates.

7. Applicants state that Goldman Sachs has previously sought and received exemptions under section 9(c) of the Act on four occasions, as described in the application.

<u>Applicants' Condition</u>:

Applicants agree that any order granting the requested relief will be subject to the following condition:

Any temporary exemption granted pursuant to the application shall be without prejudice to, and shall not limit the Commission's rights in any manner with respect to, any Commission investigation of, or administrative proceedings involving or against, the Covered Persons, including without limitation, the consideration by the Commission of a permanent exemption from section 9(a) of the Act requested pursuant to the application or the revocation or removal of any temporary exemptions granted under the Act in connection with the application.

Temporary Order:

The Commission has considered the matter and finds that Applicants have made the necessary showing to justify granting a temporary exemption.

Accordingly,

IT IS HEREBY ORDERED, pursuant to section 9(c) of the Act, that Covered Persons are granted a temporary exemption from the provisions of section 9(a), effective as of the date of the Injunction, solely with respect to the Injunction, subject to the condition in the application, until the date the Commission takes final action on an application for a permanent order.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Summary

GOLDMAN, SACHS & CO., et al.

The Commission has issued a temporary order to Goldman, Sachs & Co. (Goldman Sachs), et al., under Section 9(c) of the Investment Company Act of 1940 (Act) with respect to an injunction issued against Goldman Sachs by the U.S. District Court for the Southern District of New York on July 20, 2010. The temporary order exempts Goldman Sachs, Goldman Sachs Asset Management, L.P., Goldman Sachs Asset Management International, Goldman Sachs Hedge Fund Strategies LLC, Commonwealth Annuity and Life Insurance Company, First Allmerica Financial Life Insurance Company and Epoch Securities, Inc., as well as companies of which Goldman Sachs is or becomes an affiliated person, from the provisions of Section 9(a) of the Act until the Commission takes final action on an application for a permanent order. The Commission also has issued a notice giving interested persons until August 16, 2010, to request a hearing on the application filed by applicants for a permanent order under Section 9(c) of the Act.

Investment Company Act Release No. 29366 / July 21, 2010

Jaea Hahn / (202) 551-6870

Room 8311 / Mail Stop 8010

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62548 / July 22, 2010

INVESTMENT ADVISERS ACT OF 1940
Release No. 3055 / July 22, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3155 / July 22, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13973

In the Matter of **ANDREW D. PETROFSKY, CPA,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE 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 Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. § 200.102(e)(2)] and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Andrew Petrofsky ("Respondent" or "Petrofsky").[1]

[1] Rule 102(e)(2) provides in pertinent part: "Any ... person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission."

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.5 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Petrofsky is a certified public accountant in Alabama.

2. From November 2003 until August 2008, Petrofsky was an investment adviser representative employed by Professional Asset Strategies, LLC ("PAS"), an investment adviser registered with the Commission and based in Birmingham, Alabama. Petrofsky, 31 years old, is a resident of Birmingham, Alabama.

3. On December 3, 2009, Petrofsky pled guilty to one count of wire fraud and one count of forged security before the United States District Court for the Northern District of Alabama in *United States v. Andrew D. Petrofsky*, Crim. Information No. 2:09-cr-00435-LSC-HGD.

4. The counts of the criminal information to which Petrofsky pled guilty alleged, inter alia, that Petrofsky used his position at PAS to steal money from client accounts he managed; that Petrofsky used unauthorized wire transfers and forged checks to steal money from his clients; and that Petrofsky attempted to conceal his theft by redirecting client account statements to his home, altering the statements to disguise withdrawals, and sending the altered statements to clients.

5. On April 19, 2010, a judgment of conviction was entered against Petrofsky in *United States v. Andrew D. Petrofsky,* No. 2:09-cr-00435-LSC-HGD, in the United States District Court for the Northern District of Alabama, finding him guilty of one count of wire fraud and one count of forged security. As a result of this conviction, Petrofsky was sentenced to 44 months of imprisonment in a federal penitentiary, with three years of supervised release to follow, and ordered to pay restitution in the amount of $876,651.

IV.

In view of the foregoing, the Commission finds that Petrofsky has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice and deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Petrofsky's Offer.

Accordingly, it is hereby ORDERED:

A. that Petrofsky is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

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

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62549 / July 22, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13974

In the Matter of **William B. Blount,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 15B(c) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 15B(c) of the Securities Exchange Act of 1934 ("Exchange Act") against William B. Blount ("Blount" or "Respondent").

II.

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

III.

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

1. Blount, 56, is a resident of Montgomery, Alabama. He holds Series 7, 24, and 53 securities licenses. From 1986 through at least April 2008, he was the chairman and chief executive officer of Blount Parrish & Co., Inc., ("Blount Parrish"), an Alabama corporation registered with the Commission as a broker-dealer and a municipal securities dealer.

2. On July 14, 2010, the United States District Court for the Northern District of Alabama entered a final judgment by consent against Blount in the civil action entitled Securities and Exchange Commission v. William B. Blount, et al., Case No. CV-08-B-0761-S, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, Sections 10(b) and 15B(c)(1) of the Exchange Act and Rule 10b-5 thereunder, and Municipal Securities Rulemaking Board Rules G-17 and G-20.

3. The Commission's complaint in the civil action alleged that from July 2002 through August 2004, Blount conferred more than $156,000 in cash and benefits on a long-time friend who was the president of the Jefferson County, Alabama Commission in connection with the commission president's role in awarding county bond underwriting and swap agreement business to Blount Parrish. The complaint further alleged that to conceal the payments to the president, Blount employed another long-time friend who was a registered political lobbyist as a conduit to make the payments. In exchange, the complaint alleged, Blount Parrish was selected to participate in every county bond offering or swap agreement from March 2003 through December 2004. Blount Parrish received more than $6.7 million in fees from these transactions.

IV.

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

Accordingly, it is hereby ORDERED:

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

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

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

By the Commission,

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Casey and
Commissioner Paredes
Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT of 1933
Release No. 9129 / July 22, 2010

In the Matter of **Goldman, Sachs & Co.,** **Respondent.**	**ORDER UNDER RULE 602(e) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE RULE 602(c)(2) & 602(b)(4) DISQUALIFICATION PROVISIONS**

I.

Defendant Goldman, Sachs & Co. ("Defendant" or "Goldman") has submitted a letter, dated July 13, 2010, requesting a waiver of the Rule 602(c)(2) and 602(b)(4) disqualifications from the exemption from registration under Regulation E arising from Defendant's settlement of an injunctive action commenced by the Commission.

II.

On April 16, 2010, the Commission filed a civil injunctive action in U.S. District Court for the Southern District of New York charging Defendant with violating the antifraud provisions of the federal securities laws. In its complaint, the Commission alleged that Defendant misstated and omitted key facts regarding a synthetic collateralized debt obligation ("CDO") that hinged on the performance of subprime residential mortgage-backed securities. Defendant failed to disclose to investors vital information about the CDO, in particular the role that a major hedge fund played in the portfolio selection process and the fact that the hedge fund had taken a short position against the CDO. On July 20, 2010, pursuant to Defendant's consent, the Southern District of New York entered a Final Judgment permanently enjoining Defendant from violating Section 17(a) of the Securities Act of 1933 ("Securities Act"), requiring Defendant to pay disgorgement and a penalty, and requiring Defendant to comply with specified remedial undertakings.

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if such issuer or any of its affiliates is subject to a court order entered within the past five years "permanently restraining or enjoining such person from engaging in or continuing any

conduct or practice in connection with the purchase or sale of securities." Rule 602(b)(4); 17 C.F.R. § 230.602(b)(4). The Regulation E exemption also is unavailable for the securities of any issuer if, among other things, any investment adviser or underwriter of the securities to be offered is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer or investment adviser." Rule 602(c)(2); 17 C.F.R. § 230.602(c)(2). Rule 602(e) of the Securities Act provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(e).

IV.

Based upon the representations set forth in Defendant's request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the Order.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provisions of Rules 602(c)(2) and 602(b)(4) under the Securities Act resulting from the entry of the Order is hereby granted.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Casey and Commissioner Paredes Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9130 / July 22, 2010

SECURITIES EXCHANGE ACT OF 1934
Release No. 62556 / July 22, 2010

In the Matter of **Goldman, Sachs & Co.,** **Respondent.**	**ORDER UNDER SECTION 27A(b) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b) OF THE SECURITIES EXCHANGE ACT OF 1934, GRANTING WAIVERS OF THE DISQUALIFICATION PROVISIONS OF SECTION 27A(b)(1)(A)(ii) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b)(1)(A)(ii) OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO GOLDMAN, SACHS & CO. AND ITS AFFILIATES**

Goldman, Sachs & Co. ("Defendant" or "Goldman") has submitted a letter on behalf of itself and its affiliates, dated July 13, 2010, for a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from its settlement of an injunctive action filed by the Commission.

On April 16, 2010, the Commission filed a civil injunctive action in U.S. District Court for the Southern District of New York charging Defendant with violating the antifraud provisions of the federal securities laws. In its complaint, the Commission alleged that Defendant misstated and omitted key facts regarding a synthetic collateralized debt obligation ("CDO") that hinged on the performance of subprime residential mortgage-backed securities. Defendant failed to disclose to investors vital information about the CDO, in particular the role that a major hedge fund played in the portfolio selection process and the fact that the hedge fund had taken a short position against the CDO. On July 20, 2010, pursuant to Defendant's consent, the Southern District of New York entered a Final Judgment permanently enjoining Defendant from violating Section 17(a) of the Securities Act, requiring Defendant to pay disgorgement and a penalty, and requiring Defendant to comply with specified remedial undertakings.

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or

administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the federal securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the Commission." Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in Goldman's letter, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Judgment is appropriate and should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to Goldman and its affiliates resulting from the entry of the Judgment is hereby granted.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62557 / July 22, 2010

Admin. Proc. File No. 3-13099

In the Matter of GUY S. AMICO and SCOTT H. GOLDSTEIN	ORDER GRANTING REQUEST TO WITHDRAW PETITION FOR REVIEW AND NOTICE OF FINALITY

On June 9, 2009, an administrative law judge issued an initial decision imposing sanctions upon Guy S. Amico, president of registered broker-dealer Newbridge Securities Corporation ("Newbridge"), and Scott H. Goldstein, chief executive officer of Newbridge (together with Amico, "Respondents").[1] The law judge found that Amico and Goldstein failed reasonably to supervise Daniel M. Kantrowitz, a former trader at Newbridge, within the meaning of Sections 15(b)(4)(E) and 15(b)(6) of the Securities Exchange Act of 1934,[2] with a view to detecting and preventing Kantrowitz's violations of the registration and antifraud provisions of the federal securities laws. For these failures, the law judge barred Respondents from associating with a broker-dealer in a supervisory capacity with a right to apply for reinstatement after two years and imposed on each a civil monetary penalty of $79,000.

On July 6, 2009, our Office of the General Counsel, acting pursuant to delegated authority, issued an order granting Respondents' petition for review of the law judge's initial decision and determining, under Rule of Practice 411(c),[3] to review upon the Commission's own motion what sanctions, if any, are appropriate in this matter. The parties completed briefing as scheduled. By order dated May 20, 2010, the Office of the Secretary, acting pursuant to delegated authority, granted Respondents' request for oral argument and set the date for June 18, 2010.

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1 *Newbridge Secs. Corp.*, Initial Decision Rel. No. 360 (June 9, 2009), 96 SEC Docket 17672.

2 15 U.S.C. §§ 78*o*(b)(4)(E), (b)(6).

3 17 C.F.R. § 201.411(c).

On June 16, 2010, Respondents requested that their petition for review be withdrawn.[4] We have determined to grant Respondents' request and to dismiss review of the sanctions that we took up on our own motion.[5]

Accordingly, IT IS ORDERED that Respondents' request to withdraw their petition for review of the law judge's June 9, 2009 initial decision in this matter be, and hereby is, GRANTED; and it is further

ORDERED that our review of the sanctions to be imposed in this matter, taken in accordance with Rule of Practice 411(c), be, and it hereby is, DISMISSED.

We also hereby give notice that the June 9, 2009 initial decision of the administrative law judge has become the final decision of the Commission with respect to Amico and Goldstein. Therefore, the order in that decision imposing a bar upon each Respondent from associating with any broker or dealer in a supervisory capacity with a right to file for reinstatement after two years, and imposing on each a civil money penalty of $79,000, is hereby declared effective.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

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4 Respondents simultaneously requested that oral argument in this matter be canceled, to which the Division of Enforcement objected. The Office of the Secretary, acting pursuant to delegated authority, issued an order canceling the oral argument and noting that it could be rescheduled if the Commission deems it necessary. Given our disposition of Respondents' petition for review, we conclude that oral argument is unnecessary.

5 On November 5, 2009, after briefing of this matter was complete, Respondents filed a motion to dismiss the proceeding against them. Given Respondents' subsequent request to withdraw their appeal and our determination to grant that request, we deny as moot Respondents' motion to dismiss.

COMMODITY FUTURES TRADING COMMISSION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-62552; File No. 265-26]

Joint CFTC-SEC Advisory Committee On Emerging Regulatory Issues

AGENCY: Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC").

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 will hold a public meeting on August 11, 2010, from 9:00 am to 1:00 pm, at the CFTC's Washington, D.C. headquarters. At the meeting, the committee will continue its examination of the market events of May 6, 2010.

DATES: The meeting will be held on August 11, 2010 from 9:00 am to 1:00 pm. Members of the public who wish to submit written statements in connection with the meeting should submit them by August 10, 2010.

ADDRESSES: The meeting will take place in the first floor hearing room at the CFTC's headquarters, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581.

Written statements may be may be submitted to either the CFTC or the SEC; all submissions will be reviewed jointly by the two agencies. Please use the title "Joint CFTC-SEC Advisory Committee" in any written statement you may submit. Statements may be submitted to any of the addresses listed below. Please submit your statement to only one address.

E-mail

Jointcommittee@cftc.gov

or

rule-comments@sec.gov. If e-mailing to this address, please refer to "File No. 265-26" on the subject line.

SEC's Internet Submission Form

http://www.sec.gov/rules/other.shtml

Regular Mail

Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581, attention Office of the Secretary

or

Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F St., NE., Washington, DC 20549. Comments mailed to this address should be submitted in triplicate and should refer to File No. 265-26.

Fax

(202) 418-5521

Any statements submitted in connection with the committee meeting will be made available to the public.

FOR FURTHER INFORMATION CONTACT: Martin White, Committee Management Officer, at (202) 418-5129, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581; Ronesha Butler, Special Counsel, at (202) 551-5629, Division of Trading and Markets, Securities and

Exchange Commission, 100 F St., NE., Washington, DC 20549; or Elizabeth M. Murphy, Committee Management Officer, at (202) 551-5400, Securities and Exchange Commission, 100 F St., NE., Washington, DC 20549

SUPPLEMENTARY INFORMATION:

The agenda for the meeting will include (1) committee organizational matters and (2) hearing two industry panels presenting views and information regarding the market events of May 6, 2010.

The meeting will be webcast on the CFTC's website, www.cftc.gov. Members of the public also can listen to the meeting by telephone. The public access call-in numbers will be announced at a later date.

AUTHORITY: 5 U.S.C. app. 2 § 10(a)(2)

By the Commodity Futures Trading Commission.

Martin White

Martin White
Committee Management Officer

By the Securities and Exchange Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Committee Management Officer

Dated: July 23, 2010

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3057 / July 23, 2010

Admin. Proc. File No. 3-13579

In the Matter of

JAMES C. DAWSON
c/o Michael Martinez
Kramer Levin Naftalis & Frankel LLP
1177 Avenue of the Americas
New York, New York 10036

OPINION OF THE COMMISSION

INVESTMENT ADVISER PROCEEDING

Grounds for Remedial Action

Injunction

Respondent was permanently enjoined from violations of the federal securities laws. *Held*, it is in the public interest to bar respondent from association with any investment adviser.

APPEARANCES:

Michael Martinez and *Adam C. Ford*, of Kramer Levin Naftalis & Frankel LLP, for James C. Dawson.

Richard G. Primoff and *Charles D. Riely*, for the Division of Enforcement.

Appeal filed: January 8, 2010
Last brief received: March 29, 2010

I.

James C. Dawson, an investment adviser and sole general partner of, and investment adviser to, Victoria Investors, LP ("Victoria"), a hedge fund, appeals from an initial decision of an administrative law judge. The law judge found that Dawson had been enjoined from violating antifraud provisions of the securities laws. Based on that injunction and the factual allegations underlying it, the law judge barred Dawson from associating with any investment adviser. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

In 2008, the Commission filed a complaint ("Complaint") in an injunctive action ("Injunctive Action")[1] alleging that Dawson engaged in violations of Section 10(b) of the Securities Exchange Act of 1934,[2] and Rule 10b-5 thereunder,[3] and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940.[4] On March 20, 2009, Dawson consented to the entry of an injunction ("Consent Agreement"). He agreed that he would not contest the factual allegations of the Complaint, and agreed that the Commission could use those allegations against him in an administrative proceeding. On July 24, 2009, the district court, acting pursuant to the Consent Agreement, which it incorporated by reference, permanently enjoined Dawson and imposed $303,472 of disgorgement, $102,975 of pre-judgment interest, and a $100,000 civil penalty. We summarize the relevant facts from the Complaint below.

Dawson formed Victoria in 1982 and has been its only investment adviser and general partner. As Victoria's investment adviser, Dawson was entitled to receive 20 percent of the limited partners' annual profits as compensation. As of June 2006, Victoria had approximately twenty individual and institutional investors, all of whom were Dawson's limited partners, and approximately $13 million in assets. Dawson also had three individual advisory clients with approximately $2.8 million under management.

Between April 2003 and November 2005 (the "Relevant Period"), Dawson "acted to profit himself at the expense of his advisory clients" by unfairly allocating to himself, or "cherry picking," profitable trades he made, rather than to Victoria or his individual clients. Dawson opened a personal account for himself in April 2003 at the same clearing broker he used for trading on behalf of Victoria and his individual clients. During the Relevant Period, Dawson

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1 *SEC v. Dawson*, No 08-CV-7841 (S.D.N.Y. Sep. 9, 2008).

2 15 U.S.C. § 78j(b).

3 17 C.F.R. § 240.10b-5.

4 15 U.S.C. §§ 80b-6(1) and (2).

traded throughout the day for his clients and himself using a single "suspense account" but did not allocate his trades among his clients' accounts and his personal account until as late as 7 p.m.[5] The delayed allocation enabled Dawson to identify profitable trades and allowed him to "disproportionately allocate[] profitable trades to his personal account to the detriment of his individual clients and [Victoria] his hedge fund client."

Of the 400 trades Dawson allocated to his personal account during the Relevant Period, 98.3 percent were profitable. Only 51.7 percent of the 2,880 trades allocated to his clients over the same period were profitable (52.6 percent of the trades allocated to the Victoria limited partners, and 40.7 percent of the trades allocated to Dawson's individual clients made a profit). Neither the size of the trades, nor differing trading strategy, nor any factor other than profitability explained Dawson's allocations. Dawson's cherry picking generated $303,472 in ill-gotten gains. The Complaint alleged that Dawson never disclosed his cherry-picking scheme or the conflicts of interest arising from it to his clients or the Victoria limited partners.

The clearing broker closed Dawson's personal account in November 2005 and directed him to move all of his client accounts to another broker by the end of that calendar year. Dawson complied. The new clearing broker required Dawson to allocate trades when he placed them, which precluded further cherry picking.

Dawson also used Victoria's funds to pay non-business personal expenses, such as car service for family travel and family mobile phone bills. Dawson did not reimburse Victoria for any of these non-business charges. Dawson never disclosed these payments to the Victoria limited partners.

Shortly after the district court enjoined Dawson, we commenced this proceeding. In his answer, Dawson admitted only that he had been enjoined.[6] The Division of Enforcement filed a motion for summary disposition, which the administrative law judge granted.[7] Based on Dawson's admission and the allegations of the Complaint, the law judge found that Dawson could be sanctioned and that his conduct was egregious, recurrent, and characterized by the

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[5] The broker established this trade-allocation deadline.

[6] Dawson declined to admit or deny the other allegations in the Order Instituting Proceedings.

[7] The motion was filed under Rule of Practice 250, 17 C.F.R. § 201.250, which provides that "[a]fter a respondent's answer has been filed . . . the respondent, or the interested division may make a motion for summary disposition of any or all allegations of the order instituting proceedings with respect to that respondent." 17 C.F.R. § 201.250(a). The hearing officer "may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law." 17 C.F.R. § 201.250(b).

highest degree of scienter. The law judge also found that Dawson had not expressed remorse or given assurances against future violations and barred him from association with any investment adviser. This appeal followed.

III.

Dawson does not dispute that, during the Relevant Period, he was an investment adviser and that he was enjoined with respect to his conduct in connection with the purchase or sale of securities. We find, therefore, that the requirements of Advisers Act Section 203(f)[8] for the imposition of sanctions have been satisfied.

In assessing the need for sanctions in the public interest, we consider the following factors: the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations.[9] No single factor is dispositive.[10]

We find that an application of these factors supports the imposition of a bar. Dawson's conduct was egregious. He defrauded his investment advisory clients and his limited partners in Victoria. Investment advisers are fiduciaries with respect to their clients.[11] As a fiduciary, Dawson owed "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' clients."[12] He also owed a duty to act "in a manner consistent with the best interest of

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8 15 U.S.C. § 80b-3(f).

9 *Scott B. Gann*, Securities Exchange Act Rel. No. 59729 (Apr. 8, 2009), 95 SEC Docket 15818, 15823 (citing *SEC v. Steadman*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981)), *aff'd*, No. 09-60435 (5th Cir. 2010) (*per curiam*).

10 *Id.*

11 *SEC v. Washington Inv. Network*, 475 F.3d 392, 404 (D.C. Cir. 2007) (stating that investment advisers act "as fiduciaries" to their clients). The general partner of a hedge fund is an investment adviser who owes a duty to his or her limited partners. *See Abrahamson v. Fleschner*, 568 F.2d 862, 870 (2d Cir. 1976) (finding that "the general partners as persons who manage the funds of others for compensation are 'investment advisers' within the meaning of the [Advisers] Act").

12 *Michael Batterman*, 57 S.E.C. 1031, 1043 (2004) (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963)), *aff'd*, 121 Fed. Appx. 410 (2d Cir. 2005).

[his] client and . . . not subrogate client interests to [his] own."[13] Moreover, as an investment adviser, Dawson had a duty to limit his compensation for his advisory services to the terms agreed with his clients: "a fiduciary . . . [is] not entitled to benefit from the fiduciary relationship except to the extent provided for by fees and compensation the client expressly consents to pay."[14] Disregarding his fiduciary duties, Dawson exploited his position of trust and, for two and one-half years, consistently allocated profitable trades to himself and losing trades to his clients and limited partners, thereby benefitting himself by over $300,000 directly to the detriment of his clients. Dawson's misconduct undercuts the trust that is the foundation of the investment advisory relationship,[15] and demonstrates a lack of fitness to serve as a fiduciary, supporting the remedy of barring Dawson from such a position.[16]

Dawson's principal challenge to the imposition of a bar is that his conduct was not egregious. Dawson contends that his conduct was not egregious because his Victoria limited partners were not harmed. Dawson claims that he voluntarily reduced his Victoria compensation in 2003, 2004, and 2005 by a total of $252,403, and that these reductions made his client Victoria and its investors whole. He argues that the law judge failed to recognize that, had the trades been properly allocated, Dawson would have been entitled to his 20 percent compensation from Victoria's net profits which makes the actual loss to Victoria caused by his cherry-picking closer to the amount of his "voluntary" reductions.

We reject this contention. As explained above, our finding that Dawson's conduct was egregious is based on the nature of the violation itself, not solely on any calculation of financial harm to his clients. Dawson's dishonesty in defrauding his clients breached the trust that is the underpinning of the fiduciary relationship, regardless of whether there was any net loss of money to his clients. Moreover, Dawson's contention contradicts the factual assertions in the Complaint that he "advantaged his own account at the expense of his advisory clients accounts" and that he "disproportionately allocated profitable trades to his personal account to the detriment of his individual clients and [Victoria] his hedge fund client." Dawson is bound by the terms of the Consent Agreement not to challenge the assertions in the Complaint.

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[13] *Proxy Voting By Investment Advisers*, Investment Adviser Rel. No. IA-2106 (Jan. 31, 2003), 79 SEC Docket 2149, 2150.

[14] *Feeley & Willcox Asset Mgmt Corp.*, 56 S.E.C. 616, 640 (2003).

[15] *Id.* at 639 n.39 (holding that "an adviser's recommendations bespeak trust, not caution, because the adviser acts as a fiduciary to his or her client").

[16] *See Steadman*, 603 F.2d at 1142 (indicating that, in determining appropriate sanction, Commission may consider "violations occurring in the context of a fiduciary relationship to be more serious than they otherwise might be").

In any event, Dawson's claim does not address the financial loss to his individual clients, or the amount of funds misappropriated from Victoria for his personal expenses, neither of which he claims to have repaid in any way. In addition, Dawson does not even claim that the reduction was intended to compensate his clients for the profitable trades he took from them. Rather, he claims the reduction was intended to redress the amount by which the fund lost money in 2002.

Moreover, we question Dawson's assertions about the nature of the reductions to his compensation. The Fund's audited financial statement for 2003 explains that, during each of 2001, 2002, and 2003, Dawson took advances "against his estimated allocation of net profits," and that his estimates were overly optimistic, resulting in an overpayment to Dawson in an amount recorded as a receivable balance in the statement's assets. The statement adds that the receivable balance will be reduced "utilizing incentive allocations credited to [Dawson's] account as of December 31, 2003."[17] A similar note to the audited financial statement for 2004 explains that there were further advances against estimated allocations of net profits in 2004 that would be similarly reduced by utilizing amounts from Dawson's incentive allocations. The financial statements for these years show reductions to the receivable balance approximately equal to the amount by which Dawson claims to have voluntarily reduced his compensation for those years.[18] Given the financial statement notes that Dawson's debt from the overpayments of estimated allocations would be reduced from his compensation account, we can only conclude that this happened, and that therefore the reductions in his compensation were for the purpose of paying down the advances he had received from the fund.

Dawson additionally claims that the benign reaction of eleven of his clients to his conduct, as evidenced in letters from the clients to the law judge, shows that his conduct was not egregious. First, we note that there are no letters of support for Dawson from as many as nine limited partners or from any of the three individual advisory clients.[19] It is also not clear from the

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17 The amount in the "incentive allocations" account reflects Dawson's compensation for the year.

18 There is no audited financial statement for 2005 in the record. Victoria's tax return for 2005 indicates a further reduction of $10,000 in the net balance to the receivable, significantly less than the $70,843 reduction Dawson claims to have made "voluntarily" that year. However, the record does not indicate whether Dawson continued the pattern, begun in at least 2001, of taking additional advances against anticipated profits, resulting in further "overpayments" being added to the net balance of the receivables.

19 There were approximately twenty Victoria limited partners at the time of the fraud. Only eleven limited partners, all of them characterized as "current" investors, submitted letters supporting Dawson.

letters that all of these clients fully comprehend the gravamen of the misconduct at issue.[20] Moreover, as we have held, we look beyond the interests of particular investors in assessing the need for sanctions, to the protection of investors generally.[21]

Dawson also states that "not all conduct engaged in while acting in a fiduciary capacity is egregious." We agree. As our cases cited above make clear, however, we have consistently viewed misconduct involving a breach of fiduciary duty or dishonest conduct on the part of a fiduciary, such as the fraud committed by Dawson on his clients, as egregious. The cases Dawson cites in support are inapposite because they do not involve breaches of fiduciary duty.[22]

The remaining public interest factors also support the imposition of a bar. Dawson contends that, in the context of his long and previously unblemished career, the current episode is not recurrent, but rather an aberration. Dawson's cherry-picking scheme, however, ran for two and one-half years and involved thousands of allocation decisions and all of his advisory clients.[23] Dawson stopped cherry picking only when Victoria's clearing broker closed Dawson's

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[20] For example, Mr. Stein, whose letter is found at Tab 9 of the record, remarked with respect to Dawson's actions that during his time as an investor in Victoria he found "all of Mr. Dawson's reports to be highly satisfactory. They were always received on a timely basis and had a clear definition of what his investment objectives were." Ms. Dawson (Tab 6) stated that "[Dawson] did not fraud his partners as accused." Mr. Jacobsen (Tab 2) noted that "I believe [Dawson] made some innocent mistakes . . . ." Mr. Marvin (Tab 4) found that from his experience "there are many conflicts that may appear to favor a principal over his clients. I personally would give [Dawson] the benefit of the doubt . . . ."

[21] *Christopher A. Lowry*, 55 S.E.C. 1133, 1145 (2003) (stating that public interest analysis extends beyond interests of particular group of investors), *aff'd*, 340 F.3d 501 (8th Cir. 2003); *Arthur Lipper Corp.*, 46 S.E.C. 78, 100 (1975) (stating that "we must weigh the effect of our action or inaction on the welfare of investors as a class and on standards of conduct in the securities business generally"). In any event, ratifications of fraudulent conduct do not limit our ability to sanction that conduct. *Wilshire Discount Secs.*, 51 S.E.C. 547, 551 n.15 (1993) ("[E]ven assuming that certain investors ratified or endorsed [respondent']s action, that would not alter the objective fact that [respondent] fraudulently departed from the . . . stated use of proceeds.").

[22] *See SEC v. Todd*, 2007 WL 1574756 (S.D. Cal. 2007) (finding no fraud of any kind, only recordkeeping violations); *SEC v. Johnson*, 595 F. Supp. 2d 40 (D.D.C. 2009) (victims of fraud not clients of defendants); *SEC v. Stanard*, 2009 U.S. Dist. LEXIS 6068 (S.D.N.Y. 2009) (same).

[23] *See Jeffrey L. Gibson*, Exchange Act Rel. No. 57266 (Feb. 4, 2008) 92 SEC Docket 2104, 2108-09, *petition denied*, 561 F.3d 548 (6th Cir. 2009).

personal account and demanded that he transfer to another clearing broker. The new clearing broker required immediate allocations, ending Dawson's scheme.

Dawson's actions evince a high degree of scienter. Dawson's scheme required specific preparation and the deliberate allocation of a disproportionate number of profitable trades to his own account. Dawson's use of Victoria funds to pay the non-business expenses of his family, without reimbursement or disclosure, was a further calculated abuse of his position. His level of scienter, in our view, exacerbates the egregiousness of his misconduct.

Dawson argues that he had no scienter because he had no intention "to permanently deprive his customers" of any funds. This argument contradicts the allegations in the Complaint, however, that Dawson engaged in scienter-based offenses, and Dawson is precluded by the terms of the Consent Agreement from making such a claim. He urges that his cessation of his misconduct and reduction of his compensation before our investigation began demonstrate his lack of scienter. We have addressed these arguments above, and, for the reasons discussed there, we find them unpersuasive here.

With respect to his recognition of the wrongfulness of his conduct, Dawson's arguments that no one was harmed by his actions and that he lacked scienter are troubling indications of a failure to appreciate the seriousness of his violation of his fiduciary duty. In addition, Dawson has provided no reliable assurance that he will not repeat his misconduct. Dawson asserts that the circumstances of his case (particularly his long career with a heretofore clean disciplinary record) establish a "marked unlikelihood" of future violations. Dawson maintains that his settlement of the Injunctive Action and consequent waiver of trial and payment of monetary sanctions "prove the sincerity of his assurances against future wrongdoing and his recognition of the wrongful nature of his conduct."[24] Parties settle injunctive actions for a variety of reasons, not all of them evincing a consciousness of misconduct.[25] Moreover, even if we accept Dawson's remorse as sincere, such sincerity does not preclude the imposition of a bar.[26] Nor do we consider Dawson's clean prior disciplinary record determinative.[27] Securities professionals have

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24 In his reply, Dawson states in this regard that "actions speak louder than words." We note that Dawson's actions in settling the Injunctive Action and reducing his compensation are, at best, ambiguous, and, as noted, the assurances to which Dawson refers do not appear in the record before us.

25 *Gibson*, 92 SEC Docket at 2108.

26 *Id.*

27 *Marshall E. Melton*, 56 S.E.C. 695, 708 (2003) (imposing bar based on antifraud injunction despite clean disciplinary record); *Martin R. Kaiden*, 54 S.E.C. 194, 209 (1998)

(continued...)

an obligation to obey the law.[28] We believe that Dawson's nearly thirty-year career in the securities industry, professional credentials, and his continuing operation of Victoria establish that Dawson would, if permitted, continue to work as an investment adviser and that, in doing so, he would be presented with further opportunities to engage in misconduct.[29] We find that all these reasons create a heightened likelihood of recurrence.

Our precedent has consistently held that antifraud injunctions merit the most stringent sanctions and that "[o]ur foremost consideration must . . . be whether [the] sanction protects the trading public from further harm."[30] Antifraud injunctions have especially serious implications for the public interest[31] because the "securities business is one in which opportunities for dishonesty recur constantly."[32] We have held that "an antifraud injunction can . . . indicate the appropriateness in the public interest"[33] of a bar from participation in the securities industry and that "ordinarily, and in the absence of evidence to the contrary, it will be in the public interest to . . . suspend or bar from participation in the securities industry . . . a respondent who is enjoined from violating the antifraud provisions."[34] Accordingly, we conclude that Dawson's injunction, based on allegations that he had defrauded his advisory clients of more than $300,000 over more than two years in a manner designed to avoid detection, raises significant doubts about his integrity and his fitness to remain in the securities industry. In our view, Dawson's continued

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[27] (...continued)
(same); *see also Robert Bruce Lohman*, 56 S.E.C. 573, 582 (2003) (imposing bar in insider-trading proceeding despite clean disciplinary record).

[28] *Guy P. Riordan*, Securities Act Rel. No 9085 (Dec. 11, 2009), 97 SEC Docket 23477 (citing *Mitchell Maynard*, Advisers Act Rel. No. 2875 (May 15, 2009), 95 SEC Docket 16844, 16860 n.39), *appeal filed*, No. 10-1024 (D.C. Cir. Feb. 12, 2010)

[29] *See Charles Phillip Elliott*, 50 S.E.C. 1273, 1276 (1992) (stating that the securities industry is "a business that presents many opportunities for abuse and overreaching"), *aff'd*, 36 F.3d 86 (11th Cir. 1994) (*per curiam*).

[30] *SEC v. McCarthy*, 406 F.3d 179, 188 (2d Cir. 2005).

[31] *See Michael T. Studer*, 57 S.E.C. 890, 898 (2004) (stating that "the fact that a person has been enjoined from violating antifraud provisions 'has especially serious implications for the public interest'").

[32] *Richard C. Spangler, Inc.*, 46 S.E.C. 238, 252 (1976).

[33] *Batterman*, 57 S.E.C. at 1043 (quoting *Melton*, 56 S.E.C. at 709-10).

[34] *Melton*, 56 S.E.C. at 713. *See also Steadman*, 603 F.2d at 1140 (stating that a compelling reason supporting a bar would be that "the nature of the conduct mandates permanent debarment as a deterrent to others in the industry").

functioning as an investment adviser represents a substantial threat to investors and necessitates a bar.[35]

Dawson contends that, here, a bar is excessive because any adviser bar "for more than a minimal period of time would be the functional equivalent of a lifetime bar" and would almost certainly deprive him of his livelihood, destroy Victoria, and deprive Victoria's limited partners of "an investment that . . . has provided reliable returns in often-turbulent markets." He faults the Initial Decision's "mere inclusion of general legal propositions with no application to the individual circumstances of Mr. Dawson's case" which he claims "fails to satisfy *Steadman*'s mandate that the [law judge] actually consider whether a lesser sanction would suffice." Accordingly, Dawson urges that we "either impose no sanction or impose a lesser administrative sanction, such as a bar on Mr. Dawson's ability to acquire additional investors."[36]

We recognize the severity of the sanction. However, we believe that all the specific reasons discussed above demonstrate the remedial purpose to be served by barring an individual with a demonstrated lack of fitness to be in the industry and that a bar is necessary and in the public interest.[37] We reject Dawson's proposed modified bar because of the practical difficulties in enforcing compliance with such a proposal. We also reject his proposal, or any lesser sanction, because of the serious nature of Dawson's misconduct, our concern expressed above about the possibilities any participation by Dawson in the investment advisory industry would present for future violations, and our concern that Dawson's lack of appreciation for the wrongful nature of his conduct increases the likelihood of recurrence.

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[35] *See Gibson*, 92 SEC Docket at 2104 (barring respondent in follow-on case based on antifraud injunction); *Batterman*, 57 S.E.C. at 1042 (same); *Studer*, 83 SEC Docket at 2853 (same); *Nolan Wayne Wade*, 56 S.E.C. 748 (2003) (same); *Christopher A. Lowry*, 55 S.E.C. 1133 (2002) (same).

[36] The cases Dawson cites in support of his interpretation of *Steadman* do not apply the *Steadman* analysis and arise in district courts addressing the propriety of injunctive relief or officer-and-director bars, sanctions not at issue here. *See SEC v. Jones*, 476 F. Supp. 2d 374, 383 (S.D.N.Y. 2007) (injunctive action); *SEC v. Todd*, No. 03 Civ. 2230, 2007 WL 1574756 (S.D. Cal. May 30, 2007) (injunctive action); *SEC v. Robinson*, No. 00 Civ. 7452, 2002 WL 1552049 (S.D.N.Y. July 16, 2002) (officer-and-director bar).

[37] *Cf. Paz Secs.*, Exchange Act Rel. No. 57656 (Apr. 11, 2008), 93 SEC Docket 5122, 5131-32, *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009) (holding that, in affirming bar imposed by a self-regulatory organization, the Commission need not state why a lesser sanction would be insufficient so long as Commission has explained its reasoning sufficiently to show it has given due regard to the public interest and protection of investors).

Accordingly, having found that the public interest factors weigh heavily in favor of a bar and that there are no mitigating circumstances, we find it to be in the public interest that Dawson be barred from association with any investment adviser.

An appropriate order will issue.[38]

By the Commission (Chairman SCHAPIRO and Commissioners CASEY, WALTER, AGUILAR, and PAREDES).

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

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

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3057 / July 23, 2010

Admin. Proc. File No. 3-13579

In the Matter of

JAMES C. DAWSON
c/o Michael Martinez
Kramer Levin Naftalis & Frankel LLP
1177 Avenue of the Americas
New York, New York 10036

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that James C. Dawson be, and he hereby is, barred from association with any investment adviser.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E Harmon
Deputy Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62563 / July 23, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3158 / July 23, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13977

In the Matter of **KENNETH J. ABOD, CPA,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(iii) of the Commission's Rules of Practice[2] against Kenneth J. Abod, CPA ("Abod" or "Respondent").

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[1] Section 4C provides, in relevant part, that: "The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder."

[2] Rule 102(e)(1)(iii) provides, in pertinent part, that: "The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found...to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder."

II.

In anticipation of the institution of these proceedings, Respondent has submitted an offer of settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that:

Summary

1. These proceedings arise out of Abod's failures to comply with Generally Accepted Accounting Principles ("GAAP") at Sunrise Senior Living, Inc. ("Sunrise" or the "Company") for the year-end 2004 and the first fiscal quarter of 2005. Abod helped determine the amount of the 2004 year-end bonus accrual and was aware that Sunrise was planning to pay $1 million in 2004 bonuses in 2005 but had failed to accrue for them at 2004 fiscal year-end. Abod also instructed Sunrise employees to make an adjustment to eliminate the corporate bonus accrual account for the first quarter of 2005, ended on March 31, 2005. Sunrise would not have met previously issued earnings per share ("EPS") forecasts if it had properly accrued for bonuses at year end 2004 and the first fiscal quarter of 2005. The accounting for the corporate bonus accrual account failed to comply with GAAP, because it was probable that Sunrise was going to pay bonuses and could reasonably estimate the bonus payment amounts. Consequently, Abod caused Sunrise to issue an annual report for fiscal year 2004 and a quarterly report for the first quarter of 2005 that failed to comply with GAAP. On March 24, 2008, Sunrise filed a Form 10-K for the year ended December 31, 2007. The filing included restated audited financial statements for fiscal year 2004, and unaudited quarterly financial information for fiscal years 2005 (restated). The restatement corrected the improper accounting for the bonus accruals.

Respondent

2. **Abod**, 45, who is a licensed CPA in Virginia, was Sunrise's Treasurer from 2001 until December 1, 2005, when he resigned from the Company. As Treasurer, he was responsible for maintaining corporate forecasts, facilitating the budget process, and managing Sunrise's cash position. He was in charge of Sunrise's investor relations department from mid-2004 until December 1, 2005.

[3] The findings herein are made pursuant to Respondent's offer of settlement and are not binding on any other person or entity in this or any other proceeding.

Other Relevant Party

3. **Sunrise** is a Delaware Corporation headquartered in McLean, Virginia. Its securities are registered pursuant to Section 12(b) of the Exchange Act, and the Company's common stock trades on the New York Stock Exchange under the symbol SRZ. Sunrise is a provider of residential communities and services for the elderly. Sunrise has a fiscal year end of December 31.

Facts

4. On November 4, 2004, as part of its earnings call for the 2004 third quarter, ended on September 30, 2004, Sunrise publicly stated that it estimated its EPS would between be $.55 to $.59 per share for the fourth quarter.

5. Sunrise improperly accounted for approximately $2.8 million of 2004 bonuses so it could meet 2004 earnings guidance. Of the $2.8 million, Sunrise failed to accrue at all for approximately $1 million as of December 31, 2004. Abod helped determine the amount of the year-end bonus accrual and was aware that Sunrise was planning to pay $1 million in 2004 bonuses in 2005 but had failed to accrue for them at 2004 fiscal year-end. Sunrise's failure to accrue for the bonuses did not comply with GAAP, because it was probable that Sunrise was going to pay the bonuses and could reasonably estimate the bonus amounts. Statement of Financial Accounting Standards No. 5 ("FAS 5") requires that '[a]n estimated loss from a loss contingency . . . shall be accrued by a charge to income" if it is probable that a liability has been incurred and the amount of loss can be reasonably estimated.

6. On March 7, 2005, Sunrise reported fourth quarter earnings of $.57 per share. Sunrise's failure to treat the approximately $1 million of bonuses paid in 2005 as a 2004 expense overstated Sunrise's EPS for the 2004 fourth quarter by approximately $.03 (approximately 5%). Without the improper adjustment to the corporate bonus accrual account, Sunrise would have reported fourth quarter EPS of $.54, $.01 per share short of its fourth quarter EPS guidance.

7. On April 19, 2005, approximately two weeks after Sunrise's March 31, 2005 quarter ended, Abod prepared a spreadsheet entitled "Analysis of Q1 2005." The spreadsheet listed a number of adjustments "[n]eeded" to increase Sunrise's pre-tax income for the March 31 quarter by $2.8 million. The spreadsheet listed adjustments that would allow Sunrise to increase EPS from $.29 to $.37, the low end of its EPS forecast made on March 7, 2005. The spreadsheet included an adjustment to eliminate the 2005 year-to-date corporate bonus accrual.

8. That same day, Abod instructed Sunrise employees to eliminate the 2005 corporate bonus accrual then reflected on Sunrise's books and records, improperly boosting Sunrise's earnings by $725,000. This bonus accrual adjustment was not in accordance with GAAP because it was not the result of a determination that the payment of 2005 corporate bonuses was not probable and reasonably estimable. If Sunrise had not improperly reversed the bonus accrual, it would have missed its EPS forecast for the quarter by approximately $.02 per share.

9. On March 24, 2008, Sunrise filed a Form 10-K for the year ended December 31, 2007. The filing included restated audited financial statements for fiscal years 2004 and 2005, audited financial statements for fiscal year 2006, and unaudited quarterly financial information for fiscal years 2005 (restated) and 2006. The restatement corrected the improper accounting for the bonus accruals described in paragraphs 4-8 above.

Violations

1. Section 13(a) of the Exchange Act and Exchange Act Rules 13a-1 and 13a-13 require issuers with securities registered under Section 12 of the Exchange Act to file quarterly and annual reports with the Commission and to keep this information current. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file such reports also embodies the requirement that they be true and correct. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978). Exchange Act Rules 13a-1 and 13a-13 also require issuers to file annual and quarterly financial statements that comply with Regulation S-X. Regulation S-X, Section 4-01(a) mandates that financial statements and the accompanying notes be presented in conformity with GAAP. No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder. *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998).

2. Section 13(b)(2)(A) of the Exchange Act requires Section 12 registrants to make and keep books, records, and accounts that accurately and fairly reflect the transactions and dispositions of their assets. Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP and to maintain the accountability of assets. No showing of scienter is necessary to establish a violation of Exchange Act Sections 13(b)(2)(A) or 13(b)(2)(B). *See McNulty* at 740-741.

3. Section 13(b)(5) of the Exchange Act provides that no person shall knowingly falsify any such book, record, or account or circumvent internal controls. Exchange Act Rule 13b2-1 also prohibits the falsification of any book, record, or account subject to Exchange Act Section 13(b)(2)(A).

4. By failing to accrue for bonuses as required by FAS 5, misstating its financial results in its Form 10-K for its fiscal year 2004 and in its Form 10-Q for the first quarter of 2005, Sunrise violated Exchange Act Sections 13(a), 13(b)(2)(A), 13(b)(2)(B) and Rules 12b-20, 13a-1, and 13a-13 thereunder.

5. Abod helped determine the amount of the 2004 year-end bonus accrual and was aware that Sunrise was planning to pay $1 million in 2004 bonuses in 2005 but had failed to accrue

for them at 2004 fiscal year-end. Abod also instructed Sunrise employees to make an adjustment to eliminate the corporate bonus accrual account for the first quarter of 2005, ended on March 31, 2005. Abod knew or should have known that Sunrise's Form 10-K for the year ended December 31, 2004 and Form 10-Q for the quarter ended March 31, 2005 materially overstated Sunrise's reported net income. As a result of his conduct, Abod willfully[4] violated Exchange Act Section 13(b)(5) and Rule 13b2-1 thereunder and caused and willfully aided and abetted Sunrise's violations of Exchange Act Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and Rules 12b-20, 13a-1 and 13a-13 thereunder.

Findings

1. Based on the foregoing, the Commission finds that Abod willfully violated Exchange Act Section 13(b)(5) and Rule 13b2-1, and caused and willfully aided and abetted Sunrise's violations of Exchange Act Sections 13(a), 13(b)(2)(A), 13(b)(2)(B) and Rules 12b-20, 13a-1, and 13a-13 thereunder.

2. Based on the foregoing, the Commission finds that Abod willfully violated and willfully aided and abetted the violation of provisions of the federal securities laws and rules thereunder within the meaning of Exchange Act Section 4C and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Abod shall cease and desist from committing or causing any violations and any future violations of Section 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1, and from causing any violations and any future violations of Exchange Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) and Rules 12b-20, 13a-1, and 13a-13 thereunder.

B. Abod is denied the privilege of appearing or practicing before the Commission as an accountant.

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

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such

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[4] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62565 / July 23, 2010

Admin. Proc. File No. 3-13099

In the Matter of GUY S. AMICO and SCOTT H. GOLDSTEIN	ORDER GRANTING REQUEST TO WITHDRAW PETITION FOR REVIEW AND NOTICE OF FINALITY

On June 9, 2009, an administrative law judge issued an initial decision imposing sanctions upon Guy S. Amico, president of registered broker-dealer Newbridge Securities Corporation ("Newbridge"), and Scott H. Goldstein, chief executive officer of Newbridge (together with Amico, "Respondents").[1] The law judge found that Amico and Goldstein failed reasonably to supervise Daniel M. Kantrowitz, a former trader at Newbridge, within the meaning of Sections 15(b)(4)(E) and 15(b)(6) of the Securities Exchange Act of 1934,[2] with a view to detecting and preventing Kantrowitz's violations of the registration and antifraud provisions of the federal securities laws. For these failures, the law judge barred Respondents from associating with a broker-dealer in a supervisory capacity with a right to apply for reinstatement after two years and imposed on each a civil monetary penalty of $79,000.

On July 6, 2009, our Office of the General Counsel, acting pursuant to delegated authority, issued an order granting Respondents' petition for review of the law judge's initial decision and determining, under Rule of Practice 411(c),[3] to review upon the Commission's own motion what sanctions, if any, are appropriate in this matter. The parties completed briefing as scheduled. By order dated May 20, 2010, the Office of the Secretary, acting pursuant to delegated authority, granted Respondents' request for oral argument and set the date for June 18, 2010.

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1 *Newbridge Secs. Corp.*, Initial Decision Rel. No. 380 (June 9, 2009), 96 SEC Docket 17672.

2 15 U.S.C. §§ 78*o*(b)(4)(E), (b)(6).

3 17 C.F.R. § 201.411(c).

On June 16, 2010, Respondents requested that their petition for review be withdrawn.[4] We have determined to grant Respondents' request and to dismiss review of the sanctions that we took up on our own motion.[5]

Accordingly, IT IS ORDERED that Respondents' request to withdraw their petition for review of the law judge's June 9, 2009 initial decision in this matter be, and hereby is, GRANTED; and it is further

ORDERED that our review of the sanctions to be imposed in this matter, taken in accordance with Rule of Practice 411(c), be, and it hereby is, DISMISSED.

We also hereby give notice that the June 9, 2009 initial decision of the administrative law judge has become the final decision of the Commission with respect to Amico and Goldstein. Therefore, the order in that decision imposing a bar upon each Respondent from associating with any broker or dealer in a supervisory capacity with a right to file for reinstatement after two years, and imposing on each a civil money penalty of $79,000, is hereby declared effective.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

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4 Respondents simultaneously requested that oral argument in this matter be canceled, to which the Division of Enforcement objected. The Office of the Secretary, acting pursuant to delegated authority, issued an order canceling the oral argument and noting that it could be rescheduled if the Commission deems it necessary. Given our disposition of Respondents' petition for review, we conclude that oral argument is unnecessary.

5 On November 5, 2009, after briefing of this matter was complete, Respondents filed a motion to dismiss the proceeding against them. Given Respondents' subsequent request to withdraw their appeal and our determination to grant that request, we deny as moot Respondents' motion to dismiss.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62574 / July 26, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13978

In the Matter of **Universal Ceramics, Inc.,** **Universal Equity Partners, Inc.,** **University Real Estate Fund 10, Ltd.,** **University Real Estate Partnership V,** **Ursus Telecom Corp.,** **U.S. Diagnostic, Inc.,** **U.S. Mobile Services, Inc.,** **USR Industries, Inc., and** **Utopia Trading, 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 Universal Ceramics, Inc., Universal Equity Partners, Inc., University Real Estate Fund 10, Ltd., University Real Estate Partnership V, Ursus Telecom Corp., U.S. Diagnostic, Inc., U.S. Mobile Services, Inc., USR Industries, Inc., and Utopia Trading, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Universal Ceramics, Inc. (CIK No. 320579) is a revoked Georgia corporation located in Adairsville, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Universal Ceramics 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, 1994, which reported a net loss of $64,971 for the prior three months.

2. Universal Equity Partners, Inc. (CIK No. 1137266) is a void Delaware corporation located in Miami Beach, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Universal Equity is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2002, which reported a net loss of $18,708 for the prior nine months.

3. University Real Estate Fund 10, Ltd. (CIK No. 356311) is a Colorado limited partnership located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). University Real Estate Fund 10 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, 1995, which reported a net loss of over $10 million for the prior twelve months.

4. University Real Estate Partnership V (CIK No. 311173) is a Delaware limited partnership located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). University Real Estate Partnership V 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, 2002, which reported a net loss of $280,111 for the prior three months.

5. Ursus Telecom Corp. (CIK No. 1054748) is a dissolved Florida corporation located in Sunrise, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Ursus 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, 2000. On April 6, 2001, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Florida, and the case was terminated on January 10, 2006.

6. U.S. Diagnostic, Inc. (CIK No. 911012) is a surrendered Delaware corporation located in West Palm Beach, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). U.S. Diagnostic 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 30, 2002, which reported a net loss of over $2.17 million for the prior nine months. On September 13, 2002, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Florida, which was terminated on January 5, 2005. On December 4, 2002, the company sold substantially all of its operating assets.

7. U.S. Mobile Services, Inc. (CIK No. 1096202) is a forfeited Delaware corporation located in Lake Mary, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). U.S. Mobile is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a

Form 10-SB registration statement on May 12, 2000, which reported a net loss of over $6.53 million for the year ended December 31, 1999.

8. USR Industries, Inc. (CIK No. 316911) is a void Delaware corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). USR 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, 1997, which reported a net loss of $10,126 for the prior twelve months.

9. Utopia Trading, Inc. (CIK No. 1110394) is a Georgia corporation located in Atlanta, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Utopia Trading is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB registration statement on November 27, 2000.

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

A. Whether the allegations contained in Section II 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 them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

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

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200, 201 and 202

[RELEASE NO. 34-62575]

Amendments to the Informal and Other Procedures, Rules of Organization and Program Management, and Rules of Practice; Interim Commission Review of Public Company Accounting Oversight Board Inspection Reports and Regulation P

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is amending its Informal and Other Procedures to add a rule to facilitate interim Commission review of Public Company Accounting Oversight Board ("PCAOB") inspection reports under Section 104(h) of the Sarbanes-Oxley Act of 2002 (the "Act"), and its Rules of Organization and Program Management and Rules of Practice to delegate authority to the Chief Accountant related to these reviews. The Commission is also establishing a subpart in its Informal and Other Procedures – Regulation P – to include procedural rules relating to the PCAOB.

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

FOR FURTHER INFORMATION CONTACT: Jeffrey Cohan (Senior Special Counsel) or John Offenbacher (Professional Accounting Fellow) at (202) 551-5300, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7561.

SUPPLEMENTARY INFORMATION: The Commission is amending: (1) its Informal and Other Procedures[1] to establish a new subpart ("Regulation P"),[2] to establish

[1] 17 CFR 202 et seq.

a set of procedures to facilitate requests by registered public accounting firms for interim Commission review of PCAOB inspection reports (§ 202.140), and to redesignate existing Rule 12 (§ 202.11) as Rule 190 (§ 202.190); (2) its Rules of Organization and Program Management[3] to provide delegations of authority to the Chief Accountant related to these reviews (§ 200.30-11); and (3) its Rules of Practice[4] to reflect the new delegations of authority (§ 201.430 and § 201.431).

I. DISCUSSION OF RULE AMENDMENTS

A. Introduction

The Act established the PCAOB to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB operates under the comprehensive oversight and enforcement authority of the Commission.[5]

Consistent with that oversight, Section 104(h) of the Act provides for the opportunity of a registered public accounting firm to request interim Commission review with respect to PCAOB inspection reports. The Commission is adopting new rules to implement the Act's provisions relating to these interim review requests.

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[2] 17 CFR 202 subpart 100.

[3] 17 CFR 200 et seq.

[4] 17 CFR 201 et seq.

[5] The Act vests the Commission with oversight duties and responsibilities, including the duties to appoint the members of the PCAOB, approve PCAOB rules and professional standards for them to take effect, act as an appellate authority for PCAOB enforcement actions, and approve the PCAOB's budget and annual accounting support fee. The Commission also, among other things, may amend existing PCAOB rules, assign additional tasks to the PCAOB as appropriate, oversee the PCAOB's exercise of certain assigned powers and duties, and limit the PCAOB's activities and remove PCAOB members. See, e.g., Title I of the Act [15 U.S.C. 7211-7219].

B. Background

Section 104 of the Act requires the PCAOB to conduct a continuing program of inspections of each registered public accounting firm.[6] That section of the Act directs the PCAOB to publish a written report of its findings for each inspection.[7]

As required by the Act, PCAOB rules provide that a registered public accounting firm may review and respond to a draft inspection report.[8] However, when the PCAOB first publishes its report, no portions of the inspection report that deal with criticisms of, or potential defects in, the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the PCAOB, not later than 12 months after the date of the inspection report.[9]

Section 104 of the Act also provides that a registered public accounting firm may seek interim review by the Commission, pursuant to such rules as the Commission may promulgate, if the firm either:

(1) Has responded to the substance of particular items in the PCAOB's draft inspection report and disagrees with the assessments contained in any final report prepared by the PCAOB following that response, or

(2) Disagrees with the PCAOB's determination that quality control criticisms or defects identified in the inspection report have not been addressed to the satisfaction of the PCAOB within 12 months of the date of the inspection report.[10]

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[6] See Section 104(a) of the Act.

[7] See Section 104(g) of the Act.

[8] See Section 104(f) of the Act and PCAOB Rule 4007.

[9] See Section 104(g)(2) of the Act.

[10] See Section 104(h)(1) of the Act.

The Act further provides that a firm may request any such review within 30 days of the event that gives rise to the review.[11] We believe implicit in the language of 104(h)(1) is that the firm may seek review both with respect to items to which the firm responded to the PCAOB in connection with a draft inspection report and disagrees with the assessments relating to those items contained in any final report, as well as any assessments contained in any final inspection report that was not contained in the draft inspection report provided to the firm with which the firm disagrees (e.g., items on which the firm did not have an opportunity to comment in connection with the draft report). New Rule 140, which we are adopting today, clarifies that these are separate reviewable matters.

To implement Section 104 of the Act as to the PCAOB's basic inspection program, the Commission approved a set of rules proposed by the PCAOB.[12] These rules provide that the PCAOB will make a draft inspection report available for review by the firm that is the subject of the report, and the firm may submit a written response to the draft report, which will become part of the inspection report.[13] A separate PCAOB rule implements the Act's 12-month delay of publication of any portions of an inspection report that deal with criticisms of, or defects in, the inspected firm's quality control systems.[14] During that 12-month period, the firm that is the subject of the report may submit evidence or otherwise demonstrate to the PCAOB that it has improved its quality

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[11] See Section 104(h)(3) of the Act.

[12] See PCAOB Rules 4000-4010, PCAOB Release No. 2003-19 (October 7, 2003). The rules were approved by the Commission in Release No. 34-49787 (June 1, 2004).

[13] See PCAOB Rule 4007. See also Section 104(f) of the Act.

[14] See PCAOB Rule 4009.

control systems and remedied the defects in question. If the PCAOB determines that the firm has addressed the quality control defects and criticisms in the final report satisfactorily, the portion of the report that dealt with those defects and criticisms will not be made public.[15]

On the other hand, if the inspected firm has failed to address those defects and criticisms to the satisfaction of the PCAOB within the 12-month period mandated by Sections 104(g) and (h) of the Act, the PCAOB will take one of the following actions:

(1) If the inspected firm failed to make any submission to the PCAOB concerning the firm's efforts to address the quality control defects or criticisms, the PCAOB will make those portions of the report public upon expiration of the 12-month period;

(2) If the firm made a submission to the PCAOB concerning the firm's efforts to address the quality control defects or criticisms, but did not seek timely interim Commission review of an adverse PCAOB determination concerning those defects or criticisms, the PCAOB will make public those portions of the report that deal with criticisms of or potential defects in quality control systems that the firm has not addressed to the satisfaction of the Board upon expiration of a 30-day period during which the firm may seek Commission review; or

(3) If the inspected firm made a timely request for interim Commission review, the PCAOB will make public those portions of the report that deal with criticisms of or potential defects in quality control systems that the firm has not addressed to the satisfaction of the Board 30 days after the firm formally

[15] See Section 104(g)(2) of the Act.

requested interim Commission review, unless the Commission, by rule or order, directs otherwise.[16]

C. Rule Amendments

We are adopting new Rule 140 to provide procedures for firms to follow in requesting interim Commission review with respect to a PCAOB inspection report, including examples of the types of information that would facilitate the Commission's review. Consistent with the time periods in the Act, the rule specifies that a request for interim Commission review must be submitted to the Commission's Office of the Secretary, with a copy to the PCAOB, within 30 days following either the date the firm is provided a copy of the final inspection report (with respect to a review sought pursuant to Section 104(h)(1)(A) of the Act), or the date the firm receives notice of the PCAOB's adverse determination with respect to remediation of quality control defects or criticisms (with respect to a review sought pursuant to Section 104(h)(1)(B) of the Act).[17]

The review request should be marked "Request for Interim Commission Review with Respect to PCAOB Inspection Report." Firms seeking interim Commission review should submit, along with the review request, information that, to the extent possible, is focused on the specific matters for which review is requested, and that clearly and succinctly addresses the issues raised by the PCAOB. Generally, we expect that this information would include, but may not necessarily be limited to:

- The particular inspection report that is the subject of the request,
- The specific assessments or determinations that are the subject of the request,

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[16] See PCAOB Rule 4009(d).

[17] Time periods for purposes of Rule 140 shall be computed as provided in Rule 160 of the Commission's Rules of Practice. 17 CFR 201.160.

- The alleged errors or deficiencies in the assessments or determinations and the reasons they are believed to be in error or deficient,
- If the action relates to an adverse determination by the PCAOB with respect to remediation of quality control defects or criticisms, any actions the firm took to address criticisms or defects identified in the inspection report,[18] and
- Any supporting documentation relevant to the review including, but not limited to, any documents previously submitted to the PCAOB that the firm wishes the Commission to consider.

The rule directs the firm to provide a copy of its review request to the PCAOB simultaneously with its submission to the Commission. This is consistent with directions throughout the new rule for the firm and the PCAOB to provide copies of the information they submit to the Commission to the other party simultaneous with their submission to the Commission to provide an opportunity for both parties to be informed of each other's respective positions.

With respect to interim reviews contemplated by Section 104(h)(1)(A) of the Act, PCAOB Rule 4008 is silent regarding whether a final inspection report would be made public before an inspected firm has an opportunity to review the final inspection report and determine whether to request interim Commission review. In order to prevent the release of any final report before the inspected firm has an opportunity to seek Commission review, the new rule provides that the PCAOB shall not make a final

[18] A request with respect to Section 104(h)(1)(B) is limited to situations where the firm disagrees with a Board determination that criticisms or defects indentified in a previously issued inspection report have not been satisfactorily addressed. It is not an additional opportunity to seek review with respect to the original criticisms or defects themselves. If a firm disagrees with an original criticism or defect and wishes to request Commission review, the firm should initiate that request in accordance with Section 104(h)(1)(A) within 30 days of when the firm is originally provided a copy of the final inspection report.

inspection report publicly available until the firm that is the subject of the report has had 30 calendar days in which to seek interim Commission review, unless the firm consents in writing to earlier publication of the report. As noted above, this is consistent with the provision in PCAOB Rule 4009 that delays publication of unresolved quality control defects or criticisms for 30 calendar days in certain circumstances. New Rule 140 also provides for a similar delay of publication with respect to the possibility of a review request pursuant to Section 104(h)(1)(B) of the Act.

We do not believe that matters potentially subject to interim Commission review should be subject to publication, absent consent by the firm, before the firm's time to seek that review has expired, and we see no sufficient reason to vary this result based on whether review would be pursuant to Section 104(h)(1)(A) of the Act or Section 104(h)(1)(B) of the Act.[19] We understand this procedure may require the PCAOB to adjust its processes to account for the 30-day period for a firm to request review before initial publication of the final inspection report. However, given the standard of review articulated below with respect to the Commission's processing of such reviews, as well as the fact that the Commission may decline to grant review requests, we do not believe providing for an initial stay of the publication of a final inspection report will result in needless delays or routine appeals simply to delay publication.

New Rule 140 also provides that a timely review request by a firm will operate as an automatic stay of publication of the portions of the final inspection report that are the

[19] In particular, we believe this approach is consistent with Section 104(h) that an opportunity for interim Commission review is meant to precede publication. Further, we believe this approach is consistent with Section 104(g) of the Act, which provides that the final inspection report will be made available to the public "subject to" the Section 104(h) review process, which itself is a logical extension of the statutory requirement for the PCAOB to provide for a procedure for review before publication in accordance with Section 104(f) of the Act.

subject of the firm's review request (with respect to requests pursuant to Section 104(h)(1)(A) of the Act) or the portions of the inspection report that deal with criticism of or potential defects in the quality control systems of the firm that are the subject of the firm's review request (with respect to requests pursuant to Section 104(h)(1)(B) of the Act) unless the Commission determines otherwise, in its own discretion.

At the end of the 30 day review request period, the PCAOB shall make publicly available any portions of the final inspection report that are not the subject of the firm's review request (with respect to Section 104(h)(1)(A) of the Act) or criticisms of or potential defects in the quality control systems of the firm that are not the subject of the firm's review request (with respect to Section 104(h)(1)(B) of the Act), unless the Commission otherwise determines that such a result would not be necessary or appropriate. This helps to ensure timely publication of the portions of the report that are not subject to review. Further, if the firm fails to make a timely review request, the PCAOB shall make publicly available the final inspection report (with respect to Section 104(h)(1)(A) of the Act) or the portions of the inspection report that deal with criticism of or potential defects in the quality control systems of the firm (with respect to Section 104(h)(1)(B) of the Act).

If a timely request for interim review with respect to an inspection report is made, the Commission will notify the firm and the PCAOB within 30 calendar days of the receipt of the request as to whether the Commission in its discretion will grant the request for interim review. We believe this provides an appropriate period of time to evaluate the initial review request while balancing the interest in timely publication of inspection determinations. In considering whether to grant a review request, among the factors that

the Commission may consider are whether the review request makes a reasonable showing that review is appropriate or otherwise presents a concern. We do not intend to routinely grant review requests absent some indication of concern.

If the Commission does not grant the review request, the stay of publication is terminated upon notification to the firm and the PCAOB. If the Commission notifies the firm and the PCAOB that the request for interim review has been granted, the stay of publication shall continue unless the Commission determines otherwise in its own discretion, or unless the firm consents in writing to the PCAOB, with a copy to the Commission to earlier publication.

Rule 140 provides that where the Commission has notified the firm and the PCAOB that it is granting the request for an interim review, the PCAOB may submit responsive information or documents with the Commission, with a copy to the firm, within 15 calendar days of receipt of such notice. We believe this period of time should be reasonable given that the PCAOB drafted the final inspection report and considered the evidence for its decision.

The Commission also may request additional information, and provide a period of up to seven calendar days to respond to such request, from the firm in question, the PCAOB, and any associated person of the firm. The Commission may grant the firm or the PCAOB a period of up to seven calendar days to respond to any information obtained. This period of time is selected to balance the interest for an opportunity to respond with the expediency needed to complete the review and, if applicable, have the underlying findings or determinations published. Likewise, if the firm or the PCAOB fails to respond timely to a request from the Commission, such failure may make it impossible

for the Commission to complete its review and therefore could result in a determination adverse to the non-responsive party.[20]

The information provided by the firm, together with any additional information provided by the PCAOB or associated persons, provides a basis for Commission consideration of the review. Rule 140 provides that, based on this information, the Commission shall consider whether the PCAOB's assessments or determinations are arbitrary and capricious, or otherwise not consistent with the purposes of the Act.

Congress did not prescribe a standard of review for PCAOB inspection reports in the Act. Therefore, in establishing this standard of review, the Commission is informed by the approach that the courts have generally taken in reviewing agency action in the absence of a statutorily prescribed standard of review.[21] Further, an arbitrary and capricious standard of review creates an incentive for the firm to fully address and pursue areas of concern in the inspection report with the PCAOB, under its rules, prior to requesting review by the Commission.

At the end of its review, the Commission shall inform the firm seeking review and the PCAOB in writing that the Commission:

(1) Does not object to all or part of the PCAOB's assessments or determination and the stay of publication is terminated; or

(2) Remands to the PCAOB with instructions that the stay of publication is permanent or that the PCAOB take such other actions as the Commission deems

[20] Such failure on the part of the firm would include the failure of an "associated person" of a firm to respond.

[21] See Alaska Department of Environmental Conservation v. Environmental Protection Agency, 540 U.S. 461, 496 (2004); see also 5 U.S.C. 706(2)(A) (Administrative Procedure Act). Also, we note that this is the standard that the courts have utilized in reviewing Commission actions. See, e.g., Natural Resources Defense Council, Inc., et al. v. SEC, et al., 606 F.2d 1031, 1049 (D.C. Cir. 1979); Bradford Nat'l Clearing Corp. et al. v. SEC, 590 F.2d 1085, 1093 (D.C. Cir. 1978).

necessary or appropriate with respect to publication, including, but not limited to, revising the final inspection report or determinations before publication.

To further encourage expediency in the review process, the rule provides that the review is to be completed and written notice provided to the firm and the PCAOB no more than 75 calendar days after notification to the firm and the PCAOB that the Commission is granting the request for an interim review, unless the Commission extends the period of review for good cause. The default 75 day period allows for the maximum 15 day period in the rule for the PCAOB to respond, an opportunity for the Commission to determine if additional information is needed, the ability, if appropriate, to have at least one request for additional information and an opportunity for the other party to respond (up to seven days under the rule each), and an opportunity for the Commission to review and complete the request.

Consistent with the purpose of providing an opportunity for review before public disclosure of all or a portion of an inspection report by the PCAOB, Rule 140 provides that, unless otherwise determined by the Commission, the decision to grant or deny a review request and the results of the Commission's review shall be non-public, and the information or documents submitted, created, or obtained by the Commission or its staff in the course of the review shall be deemed non-public.[22] Further Section 104(h)(2) provides that any decision of the Commission with respect to interim review under Section 104(h) is not subject to judicial review.[23] Finally, again consistent with the

[22] See also Section 105(b)(5) of the Act. Rule 140 also provides that nothing shall be construed to impair or limit the ability of any party to request confidential treatment under the Freedom of Information Act [15 U.S.C. 7215(b)(5)], or any other applicable law. Applicants may wish to consider whether seeking confidential treatment would be appropriate.

[23] 15 USC 7214(h)(2).

limited purposes of review under Section 104(h), any action taken by the Commission relates solely to the publication of the relevant inspection report and does not imply that the firm is exonerated or that no action may ultimately result from the inspection or from an investigation by the Commission, the PCAOB, or any other party.

D. Regulation P

The Commission is establishing a separate subpart in the Commission's Informal and Other Procedures – Regulation P – to include procedural rules relating to the PCAOB in one central location. The intention is to designate Rules in Regulation P according to the Section of the Act to which they primarily relate. As such, the procedural rule regarding interim inspection report reviews, which relates primarily to Section 104 of the Act, is being designated as Rule 140. In addition, the Commission is redesignating its existing procedural rule relating to the PCAOB budget process from Rule 11 to Rule 190 given the process relates primarily to Section 109 of the Act.

E. Delegation of Authority

In connection with adopting Rule 140, the Commission also is adopting Rule 30-11 of our Rules of Organization and Program Management to delegate authority to the Commission's Chief Accountant to process interim reviews subject to Rule 140. Among other matters, the Chief Accountant is delegated authority to grant or deny requests for interim review, to extend the time periods for the PCAOB or the firm to respond under the rule, to request additional information in conjunction with the review, to make a determination with respect to the review, and to notify the PCAOB and the firm of the results of the review. This delegation of authority is intended to conserve Commission resources by permitting the Chief Accountant to fulfill the Commission's review

requirements in a timely manner. Nevertheless, the staff may submit matters to the Commission for consideration, as it deems appropriate.[24] Further, we expect that the Commission staff will process interim Commission reviews with respect to inspection reports as efficiently and expeditiously as possible to avoid any unnecessary delay in making the inspection report available to the public, as required by the Act.

II. ADMINISTRATIVE PROCEDURE ACT, REGULATORY FLEXIBILITY ACT, AND PAPERWORK REDUCTION ACT

The Commission finds, in accordance with Section 553(b)(3)(A) of the Administrative Procedure Act ("APA"),[25] that this revision relates solely to agency organization, procedure, or practice. It is, therefore, not subject to the provisions of the APA requiring notice and opportunity for public comment.[26] The Regulatory Flexibility Act,[27] therefore, does not apply. Similarly, because these rules relate to "agency organization, procedure or practice that does not substantially affect the rights or obligations of non-agency parties," analysis of major status under the Small Business Regulatory Enforcement Fairness Act is not required.[28] The rules do not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended.[29]

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[24] The Commission may also review any action taken by delegated authority. See Section 4A(b) of the Exchange Act. The Commission is revising its Rules of Practice to reflect this new delegation of authority to the Chief Accountant. Consistent with Section 104(h)(2), the Commission is also revising its Rules of Practice to provide that actions taken by delegated authority with respect to Rule 140 are not subject to judicial review.

[25] 5 U.S.C. 553(b)(3)(A).

[26] In addition, we intend to apply these procedures to pending applications, without further delay.

[27] 5 U.S.C. 601 et seq.

[28] 5 U.S.C. 804(3)(C).

[29] 44 U.S.C. 3501 et seq.

The Commission intends, after the Commission's initial experience under the new procedures, to issue a notice of comment in the future so the Commission can consider any such comments, along with the Commission's initial experience, in order to determine whether changes in pursuit of enhancements or efficiencies would be warranted.

III. CONSIDERATION OF THE COSTS AND BENEFITS OF THE RULE AMENDMENTS

We are sensitive to the costs and benefits imposed by our rules and amendments, and we have identified certain costs and benefits of these rules.

The potential benefits of the rule amendments include clarification and increased transparency of the Commission's review and oversight procedures with respect to the PCAOB[30] and the interim review procedures set forth in Rule 140, and the benefits of process: notice, opportunity to be heard, efficiency, and fairness. Rule 140 establishes a set of procedures for registered public accounting firms to follow in requesting interim Commission review with respect to a PCAOB inspection report, as required by the Act. The rule benefits inspected firms by informing them of the procedures to follow in initiating the review process and obtaining Commission review with respect to inspection findings and determinations with which they disagree. Commission review with respect to the PCAOB's inspection reports would allow the Commission to protect the public interest in the quality of PCAOB reports. It could provide a further incentive for the PCAOB to exercise diligence in its inspection and remedial determination process, including encouraging the PCAOB to make determinations on the basis of reasoned

[30] In addition, organizing Commission procedural rules relating to the PCAOB in one subpart also will make locating such rules easier.

support and sound analysis. The review procedure also benefits inspected firms by protecting against publication of inspection findings that the Commission ultimately may remand to the PCAOB for reconsideration.

There also are potential costs of the rule. Firms involved in Commission review proceedings may incur additional costs beyond those already incurred in complying with PCAOB procedures for seeking review of the inspection report's findings at the PCAOB level. However, a request for interim review of a PCAOB inspection report by the Commission is optional. Thus, a registered public accounting firm would incur these costs only if it expected the benefits from the review process to justify the costs.

The PCAOB also may incur additional costs as a result of the rule amendments, for example by adjusting its inspection process in anticipation of review requests and providing information to the Commission, especially at the Commission's request. The imposition of additional costs, beyond those already incurred by the PCAOB, could lead to higher accounting support fees assessed against issuers to cover the PCAOB's recoverable budget expenditure. To the extent the PCAOB has been publishing inspection reports before it has been feasible for firms to request interim review of findings, the public may experience a delay in publication from existing practice. However, to the extent those reports have included findings that would be remanded under Rule 140, providing an opportunity for those findings to be corrected may increase public confidence in the findings, including that the findings would not be further subject to change upon publication.

IV. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the impact on competition of any rule we adopt. The rule amendments are intended to provide additional guidance with respect to the Commission's oversight responsibilities under Sections 104 and 107 of the Sarbanes-Oxley Act. The rule amendments provide procedures for requesting Commission review with respect to inspection reports issued by the PCAOB.

Section 3(f) of the Securities Exchange Act of 1934[31] requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or in the public interest, to consider, in addition to the protection of investors, whether the action will promote competition and capital formation. We are not aware of any effect the rule amendments will have on competition, and capital formation. They are designed to enhance the transparency of the Commission's and the PCAOB's administrative practices, by facilitating the public's understanding of the Commission's oversight responsibilities with respect to PCAOB, and by promoting public confidence in the PCAOB's auditor oversight functions. The amendments may increase the efficiency of the PCAOB inspection process. Rule 140, which sets forth the administrative procedures relating to the Commission's review with respect to PCAOB inspection reports, applies to all registered public accounting firms that seek administrative review by the Commission. Therefore, the Commission does not expect the rules to have an anti-competitive effect.

V. STATUTORY BASIS AND TEXT OF RULES

The Commission is amending its Informal and Other Procedures under the authority set forth in Sections 3, 101(c)(5), 104, and 107 of the Act; and Sections 4A and

[31] 15 U.S.C. 78c(f).

23 of the Exchange Act. The amendments to the Commission's Rules of Organization and Program Management and Rules of Practice are adopted pursuant to the authorities set forth therein.

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies), Organization and functions (Government agencies).

17 CFR Part 201

Administrative practice and procedure.

17 CFR Part 202

Administrative practice and procedure, Securities.

Text of Amendments

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

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

1. The general authority citation for part 200 is revised to read as follows:

Authority: 15 U.S.C. 77o, 77s, 77sss, 78d, 78d-1, 78d-2, 78w, 78ll(d), 78mm, 80a-37, 80b-11, and 7201 et seq., unless otherwise noted.

* * * * *

2. Add § 200.30-11 to read as follows:

§ 200.30-11 Delegation of authority to the Chief Accountant.

Pursuant to the provisions of Pub. L. 101-181, 101 Stat. 1254, 1255 (15 U.S.C. 78d-1, 78d-2), the Securities and Exchange Commission hereby delegates, until the

Commission orders otherwise, the following functions to the Chief Accountant of the Commission, to be performed by him or her or under his or her direction by such person or persons as may be designated from time to time by the Chairman of the Commission:

(a) In connection with Commission review of inspection reports of the Public Company Accounting Oversight Board ("PCAOB") under 15 U.S.C. 7214(h) and § 202.140:

(1) To grant or deny review requests and notify the firm and the PCAOB as to whether the Commission will grant the review request under § 202.140(d);

(2) To extend the time periods set forth in § 202.140(e) within which the PCAOB, registered public accounting firm or an associated person may submit responsive information and documents in connection with a request for Commission review.

(3) To request additional information pursuant to § 202.140(e) relating to the PCAOB's assessments or determination under review from the PCAOB, the registered public accounting firm, or any associated person of the firm during the course of an interim review of an inspection report, and to grant the PCAOB, the firm or any associated person a period of up to seven calendar days to respond to any information obtained.

(4) To consider requests for review of inspection reports and, based on such review, to not object to all or part of the assessments or determination of the PCAOB and terminate the stay of publication, or to remand to the PCAOB with instructions that the stay of publication is permanent or that the PCAOB take such other actions as he or she deems necessary or appropriate with respect to publication, including, but not limited to,

revising the final inspection report or determinations before publication, and to provide the written notice communicating the same to the PCAOB and the registered public accounting firm, consistent with § 202.140.

(5) To determine that a timely review request by a firm will not operate as a stay of publication of those portions of the final inspection report or determinations described in § 202.140(b) that are the subject of the firm's review request pursuant to § 202.140(c)(5), as well as to determine that publication of the remainder of the final inspection report or criticisms or defects in the quality control systems would not be necessary or appropriate pursuant to § 202.140(c)(5).

(6) To, in the event the Commission does grant a review request pursuant to § 202.140, determine that the stay of publication shall not continue pursuant to § 202.140(d).

(7) To, in the event that the review pursuant to § 202.140(e) has not been completed and a written notice has not been sent 75 calendar days after notification to the firm and the PCAOB that it is granting the request for an interim review, grant an extension of time under the authority set forth in § 202.140(e).

(b) Notwithstanding anything in the foregoing, in any case in which the Chief Accountant believes it appropriate, he or she may submit the matter to the Commission.

PART 201 -- RULES OF PRACTICE

3. The authority citation for part 201 continues to read as follows:

Authority: 15 U.S.C. 77s, 77sss, 78w, 78x, 79t, 80a-37 and 80b-11; 5 U.S.C. 504(c)(1).

* * * * *

4. Section 201.430 is amended by adding the following language to the end of Section 201.430(c): “Pursuant to 15 U.S.C. 7214(h)(2), any decision by the Commission pursuant to 200.30-11 shall not be reviewable under 15 U.S.C. 78y and shall not be deemed ‘final agency action’ for purposes of 5 U.S.C. 704.”

PART 202 – INFORMAL AND OTHER PROCEDURES

5. The general authority citation for part 202 is revised to read as follows:

Authority: 15 U.S.C. 77s, 77t, 78d-1, 78u, 78w, 78ll(d), 79r, 79t, 77sss, 77uuu, 80a-37, 80a-41, 80b-9, 80b-11, and 7201 et seq., unless otherwise noted.

* * * * *

6. Add subpart 202.100, redesignate §202.11 as §202.190, and add §202.140 to read as follows:

Subpart 202.100 – Public Company Accounting Oversight Board (Regulation P)

Sec.

202.140 Interim Commission Review of PCAOB inspection reports.

202.190 Public Company Accounting Oversight Board budget approval process.

§ 202.140 Interim Commission review of PCAOB inspection reports.

(a) Definitions.

(1) Board or PCAOB means the Public Company Accounting Oversight Board.

(2) Registered public accounting firm or Firm shall have the meaning set forth in 15 U.S.C. 7201(a)(12).

(3) Associated person means a person associated with the registered public accounting firm as defined in 15 U.S.C. 7201(a)(9).

(b) Reviewable matters. A registered public accounting firm may request interim Commission review of an assessment or determination by the PCAOB contained in an inspection report prepared under 15 U.S.C. 7214 and relating to that firm, if the firm:

(1) Has provided the PCAOB with a response, pursuant to the rules of the PCAOB, to the substance of particular items in a draft inspection report and disagrees with the assessments relating to those items contained in any final inspection report prepared by the PCAOB following such response;

(2) Disagrees with an assessment contained in any final inspection report that was not contained in the draft inspection report provided to the firm under 15 U.S.C. 7214(f) or the rules of the PCAOB; or

(3) Disagrees with the determination of the PCAOB that criticisms or defects in the quality control systems of the firm that were identified in an inspection report, but not disclosed to the public, have not been addressed to the satisfaction of the PCAOB within 12 months after the date of that inspection report.

(c) Procedures for requesting interim Commission review.

(1) A request for interim Commission review with respect to matters described in paragraph (b) of this section must be submitted to the Commission's Office of the Secretary within 30 calendar days of the following:

(i) The date the firm is provided a copy of the final inspection report described in paragraph (b)(1) or (b)(2) of this section; or

(ii) The date the firm receives notice of the PCAOB's determination described in paragraph (b)(3) of this section.

(2) The PCAOB shall not make publicly available the final inspection report or criticisms or defects in the quality control systems of the firm subject to a determination described in paragraph (b) of this section, as applicable, during the 30-day period during which the firm may request interim Commission review, unless the firm consents in writing to earlier publication of the report.

(3) A request for interim Commission review ("request" or "submission") must be marked "Request for Interim Commission Review With Respect to PCAOB Inspection Report." The request must focus on the specific matters for which relief is requested and succinctly address the issues raised by the PCAOB. The request, to the extent possible, should include, for example:

(i) A copy of the particular inspection report that is the subject of the request;

(ii) The specific assessments or determinations that are the subject of the request;

(iii) The alleged errors or deficiencies in the PCAOB's assessments or determination and the reasons for the firm's position;

(iv) If the matter is being reviewed under paragraph (b)(3) of this section, any actions taken by the registered public accounting firm to address criticisms or defects identified in the inspection report; and

(v) Any supporting documentation relevant to the review.

(4) The firm must provide a copy of its review request to the PCAOB simultaneously with its submission to the Commission.

(5) A timely review request by a firm will operate as a stay of publication of those portions of the final inspection report or criticisms or defects in the quality control systems of the firm subject to a determination described in paragraph (b) of this section, as applicable, that are the subject of the firm's review request, unless the Commission otherwise determines in its own discretion. Upon expiration of the 30-day period during which the firm may request interim Commission review, the PCAOB shall make publicly available the remainder of the final inspection report or criticisms or defects in the quality control systems of the firm that were indentified in an inspection report, as applicable, that are not the subject of the firm's review request, unless the Commission otherwise determines that such a result would not be necessary or appropriate.

(6) If the firm fails to make a timely review request, pursuant to Section 104(g)(2) of the Act, the PCAOB shall make publicly available the final inspection report or criticisms or defects in the quality control systems of the firm that were indentified in an inspection report, as applicable.

(d) Procedures for granting or denying the review request. Within 30 calendar days of a timely review request, the Commission will notify the firm and the PCAOB as to whether the Commission will exercise its discretion to grant the request for an interim review. If the Commission does not grant the review request, the stay of publication is terminated upon notification to the firm and the PCAOB. If the Commission does grant the review request, the stay of publication shall continue unless the Commission determines otherwise in its own discretion, or unless the firm consents in writing to the PCAOB, with a copy to the Commission, to earlier publication.

(e) Procedures where a review request has been granted.

(1) Where the Commission has notified the firm and the PCAOB that it is granting the request for an interim review, the PCAOB may submit responsive information and documents with the Commission within 15 calendar days of receipt of such notice. The PCAOB must provide a copy of such information and documents simultaneously to the firm.

(2) During the course of the interim review, the Commission may request additional information relating to the PCAOB's assessments or determination under review, and provide a period of up to seven calendar days to respond to such request, from the PCAOB, the firm, and any associated person of the firm. The Commission may grant the firm or the PCAOB a period of up to seven calendar days to respond to any information obtained pursuant to this paragraph. The firm or the PCAOB, as applicable, shall provide simultaneously to the other party all information provided as a result of a request for additional information or responses thereto. The firm with which any associated person from whom information is requested shall provide simultaneously to the PCAOB all information provided as a result of a request for additional information or responses thereto. If the firm (including any associated person) or the PCAOB fails to respond timely to a request from the Commission, such failure may serve as the basis for the Commission to conclude its review and make a determination adverse to the non-responsive party.

(3) The Commission, based on the information submitted by the firm, the PCAOB and any associated persons, shall consider whether the PCAOB's assessments or determination are arbitrary and capricious, or otherwise not consistent with the purposes of the Act.

(4) At the conclusion of its review, the Commission shall inform the firm and the PCAOB in writing that the Commission:

(i) Does not object to all or part of the assessments or determination of the PCAOB and the stay of publication is terminated; or

(ii) Remands to the PCAOB with instructions that the stay of publication is permanent or that the PCAOB take such other actions as the Commission deems necessary or appropriate with respect to publication, including, but not limited to, revising the final inspection report or determinations before publication.

(5) The review pursuant to this section shall be completed and a written notice pursuant to this section shall be sent no more than 75 calendar days after notification to the firm and the PCAOB that the Commission is granting the request for an interim review, unless the Commission extends the period for good cause.

(f) Treatment of review.

(1) Time periods in this section shall be computed as provided in the Commission's Rules of Practice, 17 C.F.R. §201.160.

(2) Unless otherwise determined by the Commission, the decision to grant or deny a review request and the conclusions of the Commission's review shall be non-public, and the information or documents submitted, created, or obtained by the Commission or its staff in the course of the review shall be deemed non-public. Nothing in this rule shall be construed to impair or limit the ability of any party to request confidential treatment under the Freedom of Information Act, 15 U.S.C. 7215(b)(5), or any other applicable law.

(3) Pursuant to 15 U.S.C. 7214(h)(2), any decision of the Commission as a result of an interim review with respect to a PCAOB inspection report, including whether a request for review is granted or denied, shall not be reviewable under 15 U.S.C. 78y and shall not be deemed to be "final agency action" for purposes of 5 U.S.C. 704.

(4) Any action taken by the Commission relates solely to the publication of the relevant inspection report and does not affect the ability of the Commission or PCAOB to take appropriate action.

(g) Designation of address; Representation.

(1) When a registered public accounting firm first submits a request for interim Commission review, or an associated person first submits information related to a request, the firm or associated person shall submit to the Commission, and keep current, an address at which any notice or other written communication furnished to the firm or associated person may be sent, a contact name and telephone number where the firm or associated person may be reached during business hours and, if represented, the representative's name, business address, and telephone number.

(2) If the firm, PCAOB, or associated person will be represented by a representative, the initial submission of that person shall be accompanied by the notice of appearance required by § 201.102(d). The other provisions of § 201.102 with respect to representation before the Commission shall apply.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 26, 2010

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-62577; IA-3058; File No. 4-606]

Study Regarding Obligations of Brokers, Dealers, and Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Request for comment.

SUMMARY: The Securities and Exchange Commission is requesting public comment for a study to evaluate: the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with them when providing personalized investment advice and recommendations about securities to retail investors; and whether there are gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for these intermediaries.

DATES: The Commission will accept comments regarding issues related to the study on or before [Insert date 30 days from publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number 4-606 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 4-606. 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: Holly Hunter-Ceci, Division of Investment Management, at (202) 551-6825 or Emily Russell, Division of Trading and Markets, at (202) 551-5550, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

DISCUSSION:

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Under section 913 of that Act, the Commission is required to conduct a study regarding the obligations of brokers, dealers, and investment advisers.

The study will evaluate the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards. In addition, the study will evaluate whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for

brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.

For purposes of the study, the term "retail customer" means a natural person (or the legal representative of such natural person) who receives personalized investment advice about securities from a broker or dealer or investment adviser and uses such advice primarily for personal, family, or household purposes.

The Commission is required to submit a study report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives no later than 6 months after enactment of the Dodd Frank Act. In order to prepare the study report, the Commission is required to seek and consider public input, comments, and data.

Accordingly, we request comment on the following:

(1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards;

(2) whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute;

(3) whether retail customers understand that there are different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers in the provision of personalized investment advice about securities to retail customers;

(4) whether the existence of different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers is a source of confusion for retail customers regarding the quality of personalized investment advice that retail customers receive;

(5) the regulatory, examination, and enforcement resources devoted to, and activities of, the Commission, the States, and a national securities association to enforce the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers when providing personalized investment advice and recommendations about securities to retail customers, including—

(A) the effectiveness of the examinations of brokers, dealers, and investment advisers in determining compliance with regulations;

(B) the frequency of the examinations; and

(C) the length of time of the examinations;

(6) the substantive differences in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers;

(7) the specific instances related to the provision of personalized investment advice about securities in which—

(A) the regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of brokers and dealers; and

(B) the regulation and oversight of brokers and dealers provide greater protection to retail customers than the regulation and oversight of investment advisers;

(8) the existing legal or regulatory standards of State securities regulators and other regulators intended to protect retail customers;

(9) the potential impact on retail customers, including the potential impact on access of retail customers to the range of products and services offered by brokers and dealers, of imposing upon brokers, dealers, and persons associated with brokers or dealers—

(A) the standard of care applied under the Investment Advisers Act of 1940 for providing personalized investment advice about securities to retail customers of investment advisers, as interpreted by the Commission and the courts; and

(B) other requirements of the Investment Advisers Act of 1940;

(10) the potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" under section 202(a)(11)(C) of the Investment Advisers Act of 1940, in terms of—

(A) the impact and potential benefits and harm to retail customers that could result from such a change, including any potential impact on access to personalized investment advice and recommendations about securities to retail customers or the availability of such advice and recommendations;

(B) the number of additional entities and individuals that would be required to register under, or become subject to, the Investment Advisers Act of 1940, and the

additional requirements to which brokers, dealers, and persons associated with brokers and dealers would become subject, including—

(i) any potential additional associated person licensing, registration, and examination requirements; and

(ii) the additional costs, if any, to the additional entities and individuals; and

(C) the impact on Commission and State resources to—

(i) conduct examinations of registered investment advisers and the representatives of registered investment advisers, including the impact on the examination cycle; and

(ii) enforce the standard of care and other applicable requirements imposed under the Investment Advisers Act of 1940;

(11) the varying level of services provided by brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers to retail customers and the varying scope and terms of retail customer relationships of brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers with such retail customers;

(12) the potential impact upon retail customers that could result from potential changes in the regulatory requirements or legal standards of care affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations to retail customers regarding the provision of investment advice, including any potential impact on—

(A) protection from fraud;

(B) access to personalized investment advice, and recommendations about securities to retail customers; or

(C) the availability of such advice and recommendations;

(13) the potential additional costs and expenses to—

(A) retail customers regarding, and the potential impact on the profitability of, their investment decisions; and

(B) brokers, dealers, and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations, including duty of care, to retail customers; and

(14) any other considerations commenters would like to comment on to assist the Commission in determining whether to conduct a rulemaking, following the study, to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 27, 2010

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3059 / July 27, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13980

In the Matter of SPENCER INTERNATIONAL ADVISORS, INC. AND SCOTT A. SPENCER, CPA Respondents.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), against Spencer International Advisors, Inc. ("Spencer International") and Scott A. Spencer ("Spencer")(collectively "Respondents").

II.

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

III.

On the basis of this Order and Respondents' Offer, the Commission finds[1] that:

Summary

From May to October 2006, Spencer, president of Spencer International, an investment adviser registered with the Commission, induced 55 clients to purchase $5 million in promissory notes (the "Loder Notes") issued by Loder Note, LLC, a Florida limited liability company owned by a Florida developer. The developer and his wife personally guaranteed the Loder Notes. Loder Note, LLC defaulted on the Loder Notes in July 2007 and the developer and his wife failed to fulfill their obligation.

The Loder Notes offering materials Spencer International and Spencer distributed to their clients contained false and misleading information regarding the Florida developer's debts and liabilities. Specifically, the Florida developer's and his wife's financial statement, contained in the offering documents, omitted material amounts of debt and personal debt guarantees the Florida developer owed other Spencer International clients. Spencer International and Spencer also failed adequately to disclose a material conflict of interest, and failed to conduct thorough due diligence as they represented.

Respondents

1. **Spencer International** is a Florida corporation with its principal place of business in Clearwater, Florida. Spencer International has been registered with the Commission as an investment adviser since January 1994.

2. **Spencer**, CPA, age 46, resides in Bellair, Florida and was one of the owners and the former president of Spencer International. Spencer is also a certified financial planner, and a chartered mutual fund counselor. He previously maintained Series 7, 24, 28, and 63 licenses.

Other Relevant Entity

3. **Loder Notes, LLC**, was a Florida limited liability company, controlled by the Florida developer, with its principal place of business in Largo, Florida. Neither Loder Notes, LLC, nor the Loder Notes securities are registered with the Commission.

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

Background

4. Since 2000, Spencer International has recommended alternative, speculative investments for some of its clients designed to provide high income. Spencer International called these products Special Situation Investments ("SSIs"). Spencer headed Spencer International's committee that identified, evaluated, and recommended these investments to its clients.

5. Spencer International and Spencer promised to conduct thorough due diligence on SSIs. Pursuant to Spencer International's client advisory agreement, Spencer International charged clients who purchased SSIs a 3% annual fee for due diligence and administration.

6. In January 2005, some of Spencer International's clients began funding loans to finance the Florida developer's real estate development projects. Between January 2005 and April 2006, Spencer International's clients funded nine loans totaling more than $5 million to the Florida developer and his related entities.

7. In May 2006, Spencer International and Spencer recommended the Loder Notes directly to certain Spencer International's clients. The Loder Notes were four year notes yielding 15% annual interest. The Florida developer and his wife personally guaranteed the Loder Notes, and their joint financial statement was part of the offering material prepared by Loder Note LLC which Spencer International and Spencer sent clients. The Florida developer also pledged his indirect interest in another real estate venture as security for the Loder Notes.

8. The Florida developer's and his wife's joint personal financial statement was false and misleading in that it omitted material information regarding their debt and net worth. The financial statements omitted several outstanding loans for approximately $4 million that Spencer International clients had previously made to the Florida developer and his related entities. The financial statement also contained the false statement that the Florida developer and his wife had not personally guaranteed any loans, despite the fact that the Florida developer already had guaranteed several earlier loans to Spencer International clients. Spencer International and Spencer distributed the Loder Notes offering materials containing the false and misleading information to their clients when recommending the Loder Notes.

9. Spencer International and Spencer failed to conduct thorough due diligence on the Loder Notes as they represented. Instead of independently conducting due diligence on the Florida developer's finances, Spencer relied on the fact that a major national bank had recently loaned the Florida developer and his partner $40 million and Spencer believed the bank had reviewed the developer's financial statements. However, the Florida developer submitted two financial statements to Spencer: one dated March 28, 2006 that the Florida developer submitted to secure the $40 million bank loan, and another dated April 28, 2006 which was the version attached to the Loder Notes offering materials. A comparison of those financial statements would have revealed that the Florida developer's and his wife's net worth dropped by approximately 55% in one month. Spencer International and Spencer failed to analyze and seek an explanation from the

Florida developer regarding the conflicting financial statements when they recommended the Loder Notes to Spencer International's clients.

10. Spencer International and Spencer also failed to fully disclose a material conflict of interest when they recommended the Loder Notes. Spencer International and Spencer did not disclose that a portion of the Loder Notes' proceeds could benefit a Spencer relative, who was the Florida developer's partner as well as a Spencer International shareholder and outside director. Spencer knew his relative and the Florida developer jointly owed money to Spencer International clients, and that the Loder Notes gave the Florida developer unrestricted use of their proceeds. Spencer International and Spencer nevertheless disclosed to investors only that Spencer's relative was a "member of the board of directors of Spencer International" and had a "material business relationship with [the Florida developer] on other projects." This statement failed to disclose the joint debt owed by Spencer's relative and the Florida developer to Spencer International clients or that those loans were outstanding, nearing maturity, and could be satisfied with proceeds from the Loder Notes.

11. As a result of the conduct described above, Spencer International and Spencer willfully violated Sections 206(1) and 206(2) of the Advisers Act.

IV.

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

Accordingly, pursuant to Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondents Spencer International and Spencer cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the Advisers Act;

B. Respondent Spencer be, and hereby is barred from association with any investment adviser, with the right to reapply for association after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission;

C. Respondent Spencer International is censured.

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

E. Respondent Spencer International shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $75,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Spencer International 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 Glenn S. Gordon, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Miami Regional Office, 801 Brickell Ave. Suite 1800, Miami, Florida 33131.

F. Respondent Spencer shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $75,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Spencer 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 Glenn S. Gordon, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Miami Regional Office, 801 Brickell Ave. Suite 1800, Miami, Florida 33131.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62583 / July 28, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13802

In the Matter of Verint Systems Inc., Respondent.	ORDER MAKING FINDINGS AND DISMISSING ADMINISTRATIVE PROCEEDING INSTITUTED PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to accept the Offer of Settlement submitted by Verint Systems Inc. ("Verint" or "Respondent") pursuant to Rule 240(a) of the Rules of Practice of the Commission, 17 C.F.R. § 201.240(a), and to enter an order dismissing this previously instituted public administrative proceeding brought pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act").

II.

Solely for the purpose of this proceeding and any other proceeding 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 this proceeding, which are admitted, Respondent consents to the entry of this Order Making Findings And Dismissing Administrative Proceeding Instituted Pursuant To Section 12(j) of the Securities Exchange Act of 1934.

41 of 47

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:[1]

1. Verint (CIK No. 0001166399) is a Delaware corporation based in Melville, New York. Its common stock is registered with the Commission pursuant to Exchange Act Section 12(g) and is quoted on the Pink Sheets under the symbol VRNT.PK.

2. Verint is required to file reports pursuant to Exchange Act Section 13(a) and the rules and regulations thereunder, including Exchange Act Rules 13a-1 and 13a-13.

3. Verint failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder because, at the time this proceeding was instituted, Verint had not filed with the Commission a Form 10-K since April 25, 2005 or a Form 10-Q since December 12, 2005.

4. Verint has since filed with the Commission the following reports: On March 17, 2010, Verint filed a comprehensive Form 10-K covering the periods ended January 31, 2006, 2007 and 2008; on April 8, 2010, it filed a Form 10-K for the period ended January 31, 2009; and on June 18, 2010, it filed Forms 10-Q for the quarters ended April 30, July 31, and October 31, 2009.

5. Verint also failed to comply with Exchange Act Section 13(a) and Rule 13a-1 thereunder because, after this proceeding was commenced, Verint did not timely file its Form 10-K for the period ended January 31, 2010. Verint filed its Fiscal Year 2009 Form 10-K with the Commission on May 19, 2010.

6. On June 9, 2010, Verint filed its Form 10-Q for the quarter ended April 30, 2010. This report was filed on time.

7. The administrative record developed since the initiation of this proceeding makes it appropriate for this proceeding to be dismissed as to Verint.

8. Verint has consented to the entry of final judgment against it in the action encaptioned SEC v. Verint Systems Inc., Civil Action No. 10-0930-LDW-WDW (E.D.N.Y.), pursuant to which Verint is permanently enjoined from, among other things, "violating, directly or indirectly, Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder by failing to file or by filing or causing to be filed with the Commission any report required to be filed with the Commission pursuant to [Exchange Act] Section 13(a) and the rules and regulations promulgated thereunder." The United Stated District Court for the Eastern District of New York entered the final judgment on March 9, 2010.

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

IV.

On the basis of the foregoing, the Commission deems it appropriate to accept Verint's Offer:

ACCORDINGLY, IT IS ORDERED that this proceeding against Verint pursuant to Exchange Act Section 12(j) is hereby DISMISSED without prejudice.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

Release No. IA-3060; File No. S7-10-00

RIN 3235-AI17

Amendments to Form ADV

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting amendments to Part 2 of Form ADV, and related rules under the Investment Advisers Act, to require investment advisers registered with us to provide new and prospective clients with a brochure and brochure supplements written in plain English. These amendments are designed to provide new and prospective advisory clients with clearly written, meaningful, current disclosure of the business practices, conflicts of interest and background of the investment adviser and its advisory personnel. Advisers must file their brochures with us electronically and we will make them available to the public through our website. The Commission also is withdrawing the Advisers Act rule requiring advisers to disclose certain disciplinary and financial information.

DATES: *Effective Date*: [INSERT DATE 60 DAYS AFTER PUBLICATION IN FEDERAL REGISTER], 2010. *Compliance Dates*: See Section V of this release.

FOR FURTHER INFORMATION CONTACT: Vivien Liu, Senior Counsel, Don L. Evans, Senior Counsel, Daniel S. Kahl, Branch Chief, or Sarah A. Bessin, Assistant Director, at (202) 551-6787 or <IArules@sec.gov>, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

42 of 47

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission" or "SEC") is adopting amendments to rules 203-1, 204-1, 204-2, and 204-3 [17 CFR 275.203-1, 275.204-1, 275.204-2, and 275.204-3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] ("Advisers Act" or "Act");[1] and amendments to Form ADV [17 CFR 279.1] under the Advisers Act. The Commission also is withdrawing rule 206(4)-4 [17 CFR 275.206(4)-4] under the Advisers Act.

TABLE OF CONTENTS

I. INTRODUCTION

Investment advisers provide a wide range of advisory services and play an important role in helping individuals and institutions make significant financial decisions. From individuals

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1 Unless otherwise noted, when we refer to rule 203-1, 204-1, 204-2, or 204-3, or any paragraph of these rules, we are referring to 17 CFR 275.203-1, 275.204-1, 275.204-2, or 275.204-3, respectively, of the Code of Federal Regulations in which these rules are published.

and families seeking to plan for retirement or save for college to large institutions managing billions of dollars, clients seek the services of investment advisers to help them evaluate their investment needs, plan for their future, develop and implement investment strategies, and cope with the ever-growing complexities of the financial markets. Today, the more than 11,000 advisers registered with us manage more than $38 trillion for more than 14 million clients.[2]

Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own.[3] An adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict.[4] A client may use this disclosure to select his or her own adviser and evaluate the adviser's business practices and conflicts on an ongoing basis. As a result, the disclosure clients and prospective clients receive is critical to their ability to make an informed decision about whether to engage an adviser and, having engaged the adviser, to manage that relationship.

To allow clients and prospective clients to evaluate the risks associated with a particular investment adviser, its business practices, and its investment strategies, it is essential that clients and prospective clients have clear disclosure that they are likely to read and understand. For example, such disclosure could enable a prospective client to screen advisers based on disciplinary history, financial industry affiliations or compensation methods. Such screening would allow clients to avoid advisers with a disciplinary history, should they wish to do so.

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2 These figures are based on data derived from investment advisers' responses to questions on Part 1A of Form ADV reported through the Investment Adviser Registration Depository ("IARD") as of May 3, 2010. We note that these figures will change due to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. IA-2106 (Jan. 31, 2003) [68 FR 6585 (Feb. 7, 2003)] ("Proxy Voting Release").

4 *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); *In the Matter of Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

Clients also would be able to choose advisers based on affiliations and compensation methods; in some cases, the client may not be comfortable with the conflicts of interest that those affiliations and compensation methods create, while other clients may value an advisory relationship that allows for broader access to other financial services and may seek an adviser with financial industry affiliates. A prospective client may seek modifications to an investment advisory agreement to better protect the client against an investment adviser's potential conflict of interest, either by better aligning the adviser's interest with that of the client or by prohibiting a particular practice in the client's account. If an adviser is unwilling to make such modifications, a prospective client may select a different adviser.

Since 1979, the Commission has required each adviser registered with us to deliver a written disclosure statement to clients pursuant to rule 204-3 under the Advisers Act.[5] An investment adviser may use this client disclosure statement to satisfy its disclosure obligations as a fiduciary.[6] Part 2 of Form ADV sets out minimum requirements for this disclosure statement to clients, which is commonly referred to as the "brochure."[7]

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5 Advisers use Form ADV to apply for registration with us (Part 1A) or with state securities authorities (Part 1B), and must keep it current by filing periodic amendments as long as they are registered. *See* rules 203-1 and 204-1. Form ADV has two parts. Part 1(A and B) of Form ADV provides regulators with information to process registrations and to manage their regulatory and examination programs. Part 2A contains the requirements for the disclosure "brochure" that advisers must provide to prospective clients initially and to existing clients annually, and Part 2B contains information about the advisory personnel providing clients with investment advice. Prior to the amendments we are adopting today, Part 2 was designated as "Part II."

6 *See Investment Adviser Requirements Concerning Disclosure, Recordkeeping, Applications for Registration and Annual Filings*, Investment Advisers Act Release No. 664 (Jan. 30, 1979) [44 FR 7870 (Feb. 7, 1979)] ("1979 Adopting Release").

7 Items in Part 2 of Form ADV may not address all conflicts an adviser may have, and may not identify all material disclosure that an adviser may be required to provide clients. As a result, delivering a brochure prepared under Form ADV's requirements may not fully satisfy an adviser's disclosure obligations under the Advisers Act. *See* Instruction 3 of General Instructions for Part 2 of Form ADV; rule 204-3(f).

In the past, Part 2 has required advisers to respond to a series of multiple-choice and fill-in-the-blank questions organized in a "check-the-box" format, supplemented in some cases with brief narrative responses. Advisers have had the option of providing information required by Part 2 in an entirely narrative format, but few have done so.

In 2008, we proposed a different approach to enhance the disclosure statement advisers provide to their clients.[8] Instead of the check-the-box format, each adviser registered with us would provide clients with a narrative plain English brochure that describes the adviser's business, conflicts of interest, disciplinary history, and other important information that would help clients make an informed decision about whether to hire or retain that adviser. Our proposal was designed to require advisers to disclose meaningful information in a clearer format.[9] In addition, we proposed that advisers be required to file their brochures with us electronically so that we could make them available to the public on our website.[10]

We received 81 letters commenting on the Proposing Release.[11] Commenters agreed with our proposal to move to a narrative brochure,[12] although many suggested modifications to certain

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8 *Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (Mar. 3, 2008) [73 FR 13958 (Mar. 14, 2008)] ("Proposing Release").

9 *See* Proposing Release, *supra* note 8at n.6 and accompanying text.

10 *Id.* at Section II.A.3.

11 Comment letters submitted in File No. S7-10-00 are available on the Commission's website at: http://www.sec.gov/rules/proposed/s71000.shtml.

12 *See, e.g.*, comment letter of the American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities and Committee on State Regulation of Securities (June 18, 2008) ("ABA Committees Letter"); comment letter of the Consumer Federation of America (July 2, 2008) ("Consumer Federation Letter"); comment letter of Citigroup Global Markets Inc. (May 16, 2008) ("CGMI Letter"); comment letter of Fried, Frank, Harris, Shriver & Jacobson LLP (May 2, 2008) ("Fried Frank Letter"); comment letter of the Investment Adviser Association (May 16, 2008) ("IAA Letter"); comment letter of the Investment Company Institute (May 16, 2008) ("ICI Letter").

requirements.[13] After careful consideration of these comment letters, we are adopting amendments to Part 2 of Form ADV and related rules under the Advisers Act. In light of our adoption of Part 2, we also are withdrawing rule 206(4)-4, which separately required advisers to disclose to clients certain financial and disciplinary information, because our amendments render that rule largely duplicative.

II. DISCUSSION OF FORM ADV, PART 2

The revised Part 2 requirements that we are adopting today include two sub-parts, Part 2A and Part 2B.[14] Part 2A contains 18 disclosure items about the advisory firm that must be included in an adviser's brochure. We refer to Part 2B as the "brochure supplement," which includes information about certain advisory personnel on whom clients rely for investment advice. In this section, we discuss our amendments relating to each of these sub-parts, which are addressed separately because they are subject to differing content, updating and delivery requirements.

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13 *See, e.g.*, comment letter of Alternative Investment Compliance Association (May 16, 2008) ("AICA Letter"); comment letter of Capital Institutional Services, Inc. (May 16, 2008) ("CAPIS Letter"); comment letter of Shaun Eddy (May 9, 2008) ("Eddy Letter"); comment letter of the Financial Planning Association (May 16, 2008) ("FPA Letter"); Fried Frank Letter; IAA Letter; ICI Letter; comment letter of Janus Capital Management LLC (May 16, 2008) ("Janus Letter"); comment letter of Nancy Lininger (May 18, 2008) ("Lininger Letter"); comment letter of the National Association of Personal Financial Advisers (June 4, 2008) ("NAPFA Letter"); comment letter of National Compliance Services, Inc. (May 9, 2008) ("NCS Letter"); comment letter of National Regulatory Services (May 16, 2008) ("NRS Letter"); comment letter of L. A. Schnase (May 9, 2008) ("Schnase Letter"); comment letter of Sidley Austin LLP (May 23, 2008) ("Sidley Letter"); comment letter of USAA Investment Management Company/USAA Financial Planning Services Insurance Agency, Inc. (May 16, 2008) ("USAA Letter"); comment letter of Wellington Management Company, LLP (May 15, 2008) ("Wellington Letter").

14 Part 2 is a uniform form used by investment advisers registered with both the Commission and the state securities authorities. See Instruction 5 of General Instructions for Form ADV. This Release discusses the Commission's adoption of Form ADV and related rules applicable to advisers registered with the Commission. Form ADV is also used by state securities regulators to register investment advisers. It includes certain items and instructions to Part 2 (*e.g.*, Item 19 of Part 2A, Item 10 of Appendix 1 to Part 2A, and Item 7 of Part 2B) that apply only to state-registered advisers. State-registered advisers are required by state, rather than federal, law to respond to these items. Completion of these items, therefore, is not an SEC requirement, and these items are not included in this Release as an SEC rule.

A. Part 2A: Brochure Format and Content

1. Format

We are adopting a requirement that investment advisers registered with us provide prospective and existing clients with a narrative brochure written in plain English.[15] Commenters supported use of a narrative format.[16] For example, one commenter stated that "the current check-the-box format does not always result in clear and meaningful client disclosure and it presents challenges for advisers in identifying and presenting all of the types of information that should be addressed in Part 2."[17] Another commenter expressed the view that "the flexibility of a narrative format should result in clearer and more meaningful disclosures that make relevant information readily accessible to prospects and clients."[18] We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.

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15 *See* Instructions 1 and 2 of General Instructions for Part 2 of Form ADV. In many instances where we refer to "client" in this release we are referring to both an existing and prospective client.

16 *See* ABA Committees Letter; comment letter of the American Institute of Certified Public Accountants (May 20, 2008) ("AICPA Letter"); CAPIS Letter; Consumer Federation Letter; CGMI Letter; Fried Frank Letter; IAA Letter; ICI Letter; Janus Letter; comment letter of Merrill Lynch, Pierce, Fenner & Smith, Incorporated (May 16, 2008) ("Merrill Lynch Letter"); comment letter of the Money Management Institute (May 16, 2008) ("MMI Letter"); comment letter of Morgan Stanley & Co. Incorporated (May 16, 2008) ("Morgan Stanley Letter"); NAPFA Letter; comment letter of the North American Securities Administrators Association, Inc. (May 16, 2008) ("NASAA Letter"); NRS Letter; comment letter of the National Society of Compliance Professionals Inc. (May 16, 2008) ("NSCP Letter"); comment letter of Charles Schwab & Co. and Charles Schwab Investment Management, Inc. (May 16, 2008) ("Schwab Letter"); Wellington Letter.

17 NAPFA Letter.

18 Wellington Letter.

We have added an instruction to Part 2 of Form ADV to require that an adviser provide the information in a specified format.[19] We are persuaded by commenters that this format for items in the brochure will facilitate investors' comparison of multiple advisers and are adopting this requirement.[20] An adviser must respond to each item in the brochure, and must present the information in order of the items in the form, using the headings provided by the form. If an item is inapplicable to an adviser, the adviser must include the heading and an explanation that the information is inapplicable.[21] If information an adviser provides in response to one item is also responsive to another item, the adviser may cross-reference the information in the other item.[22]

Also, it is critical that advisers communicate clearly to their clients and prospective clients in the brochure. Thus, instructions to Part 2 provide that, in drafting the brochure, advisers, among other things, should use short sentences; definite, concrete, everyday words; and the active voice. In addition, the brochure should discuss only conflicts the adviser has or is reasonably likely to have, and practices in which it engages in or is reasonably likely to engage.[23] If a conflict arises or the adviser decides to engage in a practice that it has not disclosed, supplemental information must be provided to the client.

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19 Instruction 1 of General Instructions for Part 2 of Form ADV.

20 *See* ABA Committees Letter; comment letter of First Allied Securities, Inc. (May 16, 2008) ("First Allied Letter"); comment letter of Mercer Advisors (May 2, 2008) ("Mercer Letter"); NCS Letter; NRS Letter; comment letter of Reed Smith on behalf of Federated Investors, Inc. (May 16, 2008) ("Federated Letter").

21 Instruction 1 of General Instructions for Part 2 of Form ADV.

22 *Id.*

23 Instruction 2 of General Instructions for Part 2 of Form ADV.

2. Brochure Items

Part 2A, as adopted, contains 18 separate items, each covering a different disclosure topic.[24] We have drawn the items in Part 2A largely from disclosure advisers have long been required to make in response to the previous Part 2, and have added items to address new concerns or developments. Much of the disclosure required in Part 2A addresses an adviser's conflicts of interest with its clients, and is disclosure that the adviser, as a fiduciary, must make to clients in some manner regardless of the form requirements.

Some commenters urged us to require fewer items and require advisers to provide less detailed information.[25] We have reviewed carefully these suggestions and have modified some of our items in response. In some cases, however, commenters urged us to eliminate particular proposed disclosures, such as the fee schedule, that have long been required in Part 2 and provide investors essential information. Elimination of such proposed disclosures would result in clients not receiving important information they currently receive from their advisers and on which they may rely. In many other cases, further cuts would not have reduced the amount of disclosure an adviser would have to make to clients, but rather would have permitted the disclosure to be made in a different document or manner. Thus, elimination of disclosure requirements in Part 2A suggested by some commenters would be unlikely to reduce burdens or eliminate the amount of information required to be provided to clients to satisfy an adviser's fiduciary obligations.[26]

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24 Part 2A consists of a main body and an appendix, Appendix 1. Appendix 1 contains the requirements for a specialized type of firm brochure — a wrap fee program brochure — and requires disclosure similar to current Schedule H of Part 2 of Form ADV. *See* rule 204-3(d); Appendix 1 to Part 2A; *infra* note 182 and accompanying text.

25 *See, e.g.*, comment letter of the Financial Service Institute (May 16, 2008) ("FSI Letter"); Schwab Letter; comment letter of the Securities Industry and Financial Markets Association (May 16, 2008) ("SIFMA Letter"); comment letter of Sutherland Asbill & Brennan LLP (May 16, 2008) ("Sutherland Letter").

26 Advisers with fewer conflicts and simpler business arrangements will be able to prepare shorter brochures.

We agree that disclosure to clients should be succinct and readable. We note that advisers, because of how they choose to present their programs or services to clients or the complexity of their disclosures, have the ability to take steps that would limit the length of their brochures. For example, advisers may create separate brochures for different types of advisory clients, each of which may be shorter, clearer, and contain less extraneous information than would a combined brochure.[27] Advisers that choose to disclose more than is required by the form (and their fiduciary obligations) will create lengthier brochures than those that take a more focused approach. Advisers with a more complicated offering of advisory services (or business arrangements) might consider including a summary in the beginning of their brochure, followed by a more detailed discussion of each item in the brochure. We have amended the instructions to clarify that including a summary is permissible.[28]

Below, we discuss each of the items in the form and the modifications we have made from our proposal.

Item 1. Cover Page. Item 1 requires that an adviser disclose on the cover page of its brochure the name of the firm, its business address, contact information, website (if it has one), and the date of the brochure. The cover page also must include a statement that the brochure has

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27 *See* rule 204-3(e) (allowing advisers that provide substantially different advisory services to different clients to provide clients with different brochures as long as each client receives all information about the services and fees that are applicable to that client). Note that an adviser may not omit any information required by Item 9 of Part 2A (Disciplinary Information) in any brochure provided to any client, and that each brochure must be filed through IARD. *See* rule 204-3(a); *see also* Instruction 2 for Part 2A of Form ADV. An adviser that creates separate brochures must file each brochure through the IARD system. *See* Instruction 9 for Part 2A of Form ADV.

28 *See* Instruction 8 of Instructions for Part 2A of Form ADV. We have also added an instruction to Part 2 explaining that advisers must provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest the adviser has and the business practices in which it engages, and can give his or her informed consent to the transaction or practice that gives rise to the conflict or to reject the transaction or practice. *See* Instruction 3 of General Instructions for Part 2 of Form ADV.

not been approved by the Commission or any state securities authority. If an adviser refers to itself as a "registered investment adviser," it also must include a disclaimer that registration does not imply a certain level of skill or training.[29]

The item reflects one change from our proposal. Item 1 requires an adviser to disclose on the cover page of the brochure only a general telephone number and/or e-mail address that clients can use to contact the adviser if they have questions about the brochure. Commenters asserted that some larger advisers would find it cumbersome to comply with our proposal, which would have required the name and phone number of a specific individual or service center.[30]

Item 2. Material Changes. Item 2 requires that an adviser amending its brochure identify and discuss the material changes since the last annual update on the cover page or the following page or as a separate document accompanying the brochure.[31] This item is designed to make clients aware of information that has changed since the prior year's brochure and that may be important to them.

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29 We have observed that the emphasis on SEC registration, in some advisers' marketing materials, appears to suggest that registration either carries some official imprimatur or indicates that the adviser has attained a particular level of skill or ability. Section 208(a) of the Advisers Act [15 U.S.C. 80b-8(a)] makes such suggestions unlawful.

30 *See* First Allied Letter; IAA Letter; SIFMA Letter.

31 Advisers may include the summary in their brochure or in a separate document. Item 2 of Part 2A. A summary prepared as a separate document can be used to satisfy an adviser's annual client delivery obligations. See rule 204-3(b)(2), discussed in Section II.A.3 below. Summaries provided as a separate document must be filed with the Commission as an exhibit to Part 2. *See* Note to paragraphs (a) and (b) of rule 204-1; Instruction 6 for Part 2A of Form ADV. If an adviser includes the summary of material changes in its brochure, and amends its brochure on an interim basis between annual updating amendments, the adviser should consider whether it should update its summary of material changes to avoid confusing or misleading clients reading the updated brochure. *See* Note to Instruction 6 for Part 2A of Form ADV.

Several commenters supported this requirement, agreeing that advisers can achieve meaningful disclosure with an annual disclosure highlighting changes to the brochure.[32] Others expressed concern that advisers would write lengthy summaries to avoid liability.[33] We emphasize that we intend this document to be a *summary* that identifies and broadly discusses the material changes,[34] and that it should *not* be a lengthy discussion that replicates the brochure itself.[35] Instead, the summary need contain no more than necessary to inform clients of the substance of the changes to the adviser's policies, practices or conflicts of interests so that they can determine whether to review the brochure in its entirety or to contact the adviser with questions about the changes.

Item 3. Table of Contents. Item 3 requires each adviser to include in its brochure a table of contents detailed enough to permit clients and prospective clients to locate topics easily. Some commenters supported the use of a table of contents but urged the Commission to mandate

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32 *See* ASG Letter; comment letter of the CFA Institute Centre for Financial Market Integrity (May 22, 2008) ("CFA Institute Letter"); Consumer Federation Letter; FPA Letter; IAA Letter; Janus Letter; NASAA Letter.

33 *See* AICA Letter; FSI Letter; ICI Letter; comment letter of Jackson, Grant Investment Advisers, Inc. (May 26, 2008) ("Jackson Letter"); comment letter of Katten Muchin Rosenman LLP (May 16, 2008) ("Katten Letter"); Mercer Letter; Morgan Stanley Letter; NSCP Letter; comment letter of the Financial Service Roundtable (May 16, 2008) ("Roundtable Letter"); SIFMA Letter; Sutherland Letter.

34 We have revised Item 2 to require advisers not only to identify, but also to "discuss" material changes to clarify our intent.

35 A few commenters also sought clarification of the term "material changes." *See* comment letter of the American Council of Life Insurance (May 16, 2008) ("ACLI Letter"); Fried Frank Letter; FSI Letter; IAA Letter; Roundtable Letter; comment letter of T. Rowe Price Associates, Inc. (May 16, 2008) ("T. Rowe Letter"). The standard of materiality under the Advisers Act is whether there is a substantial likelihood that a reasonable investor (here, client) would have considered the information important. *See S.E.C. v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992). *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988); *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 445, 449 (1976). This is a facts and circumstances test, requiring an assessment of the "total mix of information," in the characterization of the Supreme Court. *TSC Industries*, 426 U.S. at 449. Given that materiality depends on the factual situation, which may vary with each situation, we do not believe that it is appropriate to specifically define or provide any bright line tests for what is and is not material.

a uniform format so that investors can compare brochures of multiple advisers more easily.[36] Others opposed a uniform format, arguing that flexibility would enable an adviser to best convey information about its firm to clients.[37] As discussed above, we are persuaded by commenters that a uniform format for items in the brochure will facilitate investors' comparison of multiple advisers and are adopting this requirement. We therefore added an instruction to Part 2 of Form ADV to require advisers to present the information in the order of the items in the form, using the headings provided by the form.[38]

Item 4. Advisory Business. Item 4 requires each adviser to describe its advisory business, including the types of advisory services offered, whether it holds itself out as specializing in a particular type of advisory service, and the amount of client assets that it manages. In computing the amount of client assets that it manages, an adviser may use a method that differs from the method used in Part 1A of Form ADV to report "assets under management."[39] An adviser opting to use a different method must keep documentation describing the method used.[40]

Two commenters urged the Commission not to require that advisers make additional disclosure if they hold themselves out as specializing in a particular type of advisory service. One was concerned that advisers would have interpretive problems in defining specialized advisory services and that disclosure describing specialized services would not provide

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36 *See supra* note 20.

37 *See* Fried Frank Letter; Janus Letter; Lininger Letter.

38 Instruction 1 of General Instructions for Part 2 of Form ADV.

39 For an explanation of Part 1A's requirements for computing "assets under management," see Instruction 5.B for Part 1A of Form ADV.

40 *See* rule 204-2(a)(14)(ii) and Note to Item 4.E of Part 2A.

meaningful information to clients.[41] The other argued that Item 8 (Strategies and Risks) covers similar information.[42] As we explained in the Proposing Release, we require that advisers identify a specialized advisory service because we believe that clients likely will want to understand this before engaging that adviser.[43] Accordingly, we are adopting this item as proposed.

Commenters were divided on whether we should require investment advisers to calculate the amount of their assets in a manner consistent with the instructions for Part 1A in order to avoid confusion.[44] The methodology for calculating assets required under Part 1A is designed for a particular purpose (*i.e.*, for making a determination as to whether an adviser should register with the Commission or with the states), rather than to convey meaningful information about the scope of the adviser's business. Thus, we are permitting advisers to use a different methodology for Part 2A disclosure.[45]

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41 *See* NAPFA letter.

42 *See* Sutherland Letter.

43 *See* Proposing Release at Section II.A.2.

44 The CFA Institute Letter, IAA Letter, Janus Letter, Mercer Letter, and NRS Letter argued that the calculation requirements should be the same. Others supported our proposal that would permit advisers to use a different calculation of assets under management than the one required for Part 1A, with most of these commenters arguing that this flexibility would allow advisers to more accurately portray the business of the firm and total assets managed. *See* comment letter of Ashland Compliance Group LLC (May 16, 2008) ("Ashland Letter"); Lininger Letter; MMI Letter; Morgan Stanley Letter.

45 For example, in calculating "assets under management," for purposes of Part 1A, an adviser may include the entire value of a managed portfolio, but only if at least 50% of the portfolio's total value consists of securities. *See* current Form ADV: Instructions for Part 1A of Form ADV. Thus, for Part 1A purposes, an adviser will not include other assets (including securities) that it manages in a "non-securities" portfolio. The Part 1A formula for calculating assets under management was designed based on considerations related to the National Securities Markets Improvement Act of 1996 division of responsibility for regulation of advisers between the Commission and state securities regulatory authorities. Pub. L. No. 104-290, 110 Stat. 3416 (1996).

Finally, several commenters urged that we permit an adviser to update the amount of assets under management only in its annual updating amendment rather than (as we proposed) at the time an adviser makes an interim update to its brochure if the amount had become materially inaccurate.[46] We believe that our proposal appropriately balanced the burdens that would be imposed on advisers by having to amend their brochures repeatedly with the need to provide clients with reasonably current information. Therefore, we are adopting this instruction as proposed.[47] Advisers must update the amount of their assets under management annually (as part of their annual updating amendment) and make interim amendments only for material changes in assets under management when they are filing an "other than annual amendment" for a separate reason. As we have noted, as a fiduciary, an adviser has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship, which could include a material change to assets under management.[48]

Item 5. Fees and Compensation. Item 5 requires that an adviser describe in its brochure how it is compensated for its advisory services, provide a fee schedule, and disclose whether fees are negotiable.[49] An adviser must disclose whether it bills clients or deducts fees directly from clients' accounts, and how often it assesses fees (or bills clients).[50] The item also requires each adviser to describe the types of other costs, such as brokerage, custody fees and fund expenses

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46 *See* Morgan Stanley Letter; MMI Letter.

47 *See* Note to Instruction 4 of General Instructions for Form ADV.

48 Note to Instruction 2 of Instructions for Part 2A of Form ADV. Disclosure updating the adviser's assets under management could be provided to clients by means other than the brochure. We have brought enforcement actions charging advisers with engaging in fraud by misrepresenting their assets under management to advisory clients and prospective clients, including in advisory brochures. *See, e.g., SEC v. Locke Capital Management, Inc. and Leila C. Jenkins*, Litigation Release No. 20936 (Mar. 9, 2009) (settled order).

49 *See* Item 5.A of Part 2A.

50 *See* Item 5.B of Part 2A.

that clients may pay in connection with the advisory services provided to them by the adviser.[51] An adviser charging fees in advance must explain how it calculates and refunds prepaid fees when a client contract terminates.[52]

Item 5 also requires an adviser that receives compensation attributable to the sale of a security or other investment product (*e.g.*, brokerage commissions), or whose personnel receive such compensation, to disclose this practice and the conflict of interest it creates, and to describe how the adviser addresses this conflict.[53] Such an adviser also must disclose that the client may purchase the same security or investment product from a broker that is not affiliated with the adviser.[54]

Some commenters expressed strong support for these disclosure requirements, with one commenter stating that such disclosure is "essential to a healthy adviser-client relationship."[55] Others argued generally that most of the information is not relevant for many clients, and specifically that providing a complete set of fee schedules would impose an undue burden on

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51 *See* Item 5.C of Part 2A.

52 *See* Item 5.D of Part 2A. Item 18 of Part 2A also requires the disclosure of certain financial information about an adviser that requires prepayment of fees.

53 *See* Item 5.E of Part 2A. Because of this conflict of interest, advisers are required by the antifraud provisions of the Advisers Act to disclose their receipt of transaction-based compensation to clients. We have brought enforcement actions charging advisers with failures to make such disclosures. *See, e.g.*, *In the Matter of Financial Design Associates, Inc. and Albert L. Coles, Jr.*, Investment Advisers Act Release No. 2654 (Sept. 25, 2007) (settled order); *In the Matter of IMS, CPAs & Associates, Vernon T. Hall, Stanley E. Hargrave, and Jerome B. Vernazza*, Investment Advisers Act Release No. 1994 (Nov. 5, 2001) (settled order) (petitioners' appeal denied in *Vernazza v. SEC*, 327 F.3d 851 (9th Cir. 2003)).

54 *See* Item 5.E.2 of Part 2A. In addition to the requirement in Item 5.E.2 of Part 2A, an adviser that receives more than half of its revenue from commissions and other sales-based compensation must explain that commissions are the firm's primary (or, if applicable, exclusive) form of compensation. *See* Item 5.E.3 of Part 2A. An adviser that charges advisory fees in addition to commissions or markups to an individual client must disclose whether it reduces its fees to offset the commissions or markups. *See* Item 5.E.4 of Part 2A.

55 *See* comment letter of the Certified Financial Planner Board of Standards, Inc. (May 29, 2008) ("CFP Board Letter"). The ASG Letter, the CFA Institute Letter, the Lininger Letter, and the NRS Letter also expressed strong support for most of these requirements.

advisers.[56] We disagree with commenters who favored a broad elimination of fee information from the brochure. Information about fees is important to clients and can be used to compare fees of different advisers.[57] More persuasive, however, were arguments that brochure fee information is likely not useful to institutional and large, sophisticated clients who are often in a position to negotiate fee arrangements with their adviser and for whom, therefore, a fee table would have little utility.[58] These arguments have persuaded us to provide an exception which permits an adviser to omit disclosure of its fee schedule and the other information in Item 5.A in any brochure provided only to clients who are "qualified purchasers."[59]

A few commenters urged us to not require description of other types of fees or expenses because, among other things, such fees may vary significantly among clients and disclosure regarding them may confuse clients.[60] However, this simple and brief disclosure (which is not required to include the amount or range of the fees) may be helpful to investors unacquainted

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56 *See* comment letter of Eric A. Brill (Apr. 26, 2008) ("Brill Letter"); IAA Letter. The IAA Letter stated that larger firms may have to prepare extremely long fee schedules. They urged the Commission to provide flexibility regarding fee schedule disclosure as long as the fee is fully disclosed in the advisory contract. One commenter suggested that we amend General Instruction 4, which permits advisers to update any change to its fee schedules only annually, reasoning that potential clients would need this updated information in selecting advisers. *See* NASAA Letter. The exception contained in the instruction is designed to prevent an adviser from having to make multiple interim amendments as a result of small changes in a fee schedule each of which may be material only to certain affected clients or prospective clients who would learn of them when considering whether to enter into an advisory agreement that would reflect a revised fee. On balance, we believe that an annual update may be sufficient.

57 This information may be particularly useful to clients searching for an adviser by comparing information on brochures that will be available on the Internet.

58 *See* IAA letter; Wellington Letter.

59 "Qualified purchasers," as defined under section 2(a)(51)(A) of the Company Act [15 USC 80a-2(a)(51)(A)], include, among others, natural persons who own $5 million or more in investments and persons who manage $25 million or more in investments for their account or other accounts of other qualified purchasers.

60 *See* NAPFA Letter; NRS Letter; NSCP Letter.

with the practices of an adviser or the ancillary costs of actively managed investing. Therefore, we are adopting this disclosure requirement, as proposed.

As noted above, Item 5 also requires an adviser that receives transaction-based compensation, or whose personnel receive such compensation, to disclose this practice and the conflict of interest it creates and to describe how the adviser addresses this conflict. Some commenters argued that this item inappropriately implies endorsement of a "fee-based" compensation structure over a "commission-based" structure.[61] That is not our intent. The item simply recognizes that an adviser that accepts compensation from the sale to a client of securities has an incentive to base investment recommendations on the amount of compensation it will receive, rather than on the client's best interests, and thus involves a significant conflict of interest.[62] As a result, we are adopting the requirement as proposed.[63]

Item 6. Performance-Based Fees and Side-By-Side Management. Item 6 requires an adviser that charges performance-based fees or that has a supervised person who manages an account that pays such fees to disclose this fact. If such an adviser also manages accounts that are not charged a performance fee, the item also requires the adviser to discuss the conflicts of

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61 *See* FSI Letter; Sutherland Letter.

62 Moreover, the item is not, in substance, different from the previous Item 9 of Part 2, which, in recognition of this conflict, required an adviser to disclose whether the adviser effects securities transactions for clients. *See also supra* note 53; *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 16, 1987) [52 FR 38400 (Oct. 16, 1987)] ("Release 1092").

63 We note that nothing in the Advisers Act precludes an adviser from accepting transaction-based compensation. However, an adviser that receives compensation in connection with the purchase or sale of securities should carefully consider the applicability of the broker-dealer registration requirements of the Securities Exchange Act of 1934.

interest that arise from its (or its supervised person's) simultaneous management of these accounts, and to describe generally how the adviser addresses those conflicts.[64]

Two commenters explicitly supported this requirement.[65] Two other commenters urged us to eliminate it, arguing that the required disclosure already should be in Item 5 (Fees and Compensation) or is required by other items.[66] As discussed in the Proposing Release, an adviser charging performance fees to some accounts but not others faces a variety of conflicts of interest.[67] The number of advisers with these arrangements has grown, and we believe that it is important that clients and prospective clients receive disclosure regarding these conflicts and how the adviser addresses them.[68] While Item 5 requires disclosure of an adviser's fee arrangements, it does not specifically require disclosure of the conflicts any particular fee arrangement may create other than with respect to transaction-based compensation.

Item 7. Types of Clients. Item 7 requires that the brochure describe the types of advisory clients the firm generally has, as well as the firm's requirements for opening or maintaining an

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64 As fiduciaries, advisers must disclose all material information regarding any proposed performance fee arrangements as well as any material conflicts posed by the arrangements. *See Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Investment Advisers Act Release No. 1731, at nn.13-14 and accompanying text (July 15, 1998) [63 FR 39022 (July 21, 1998)].

65 *See* CFA Institute Letter; Lininger Letter.

66 *See* IAA Letter; Schnase Letter.

67 *See* Proposing Release, at nn.51-53 and accompanying text. An adviser charging performance fees to some accounts faces a variety of conflicts because the adviser can potentially receive greater fees from its accounts having a performance-based compensation structure than from those accounts it charges a fee unrelated to performance (*e.g.*, an asset-based fee). As a result, the adviser may have an incentive to direct the best investment ideas to, or to allocate or sequence trades in favor of, the account that pays a performance fee. We have brought enforcement actions charging advisers with undisclosed conflicts in regard to accounts that pay performance fees. *See*, *e.g.*, *In the Matter of Nevis Capital Management, LLC, et al.*, Investment Advisers Act Release No. 2214 (Feb. 9, 2004) (settled order). *See also In the Matter of Alliance Capital Management, L.P.*, Investment Advisers Act Release No. 2205 (Dec. 18, 2003) (settled order).

68 According to data derived from investment advisers' responses to Item 5.E of Part 1A of Form ADV reported through IARD as of May 3, 2010, approximately 28% of SEC-registered investment advisers reported charging performance-based fees to some accounts but not others.

account, such as minimum account size. One commenter recommended that we eliminate this proposed disclosure requirement, arguing that the information is not material to the decision of whether to hire or retain an investment adviser.[69] We disagree. We believe that many prospective clients would consider the type of clients to be an important factor in determining whether an adviser's business model is a good fit for them.[70] As a result, we are adopting Item 7 as proposed.

Item 8. Methods of Analysis, Investment Strategies and Risk of Loss. Item 8 requires that advisers describe their methods of analysis and investment strategies and disclose that investing in securities involves risk of loss which clients should be prepared to bear.[71] Item 8 also requires specific disclosure of how strategies involving frequent trading can affect investment performance. Finally, this item requires that advisers explain the material risks involved for each significant investment strategy or method of analysis they use and particular type of security they recommend, with more detail if those risks are unusual.

Several commenters supported this proposed disclosure requirement as central to the adviser's fiduciary relationship with its client.[72] One objected, stating that the item creates a different disclosure obligation for multi-strategy firms because, as proposed, it only required advisers primarily using a particular strategy to discuss the risks involved in their strategy.[73] We agree that advisers should disclose material risks associated with their strategies that will be

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69 *See* Sutherland Letter.

70 We note that disclosure of this information is already required in the previous Item 2 of Part 2 of Form ADV.

71 We have brought enforcement actions charging advisers with omissions and misrepresentations regarding investment strategies. *See, e.g.*, *In the Matter of George F. Fahey*, Investment Advisers Act Release No. 2196 (Nov. 24, 2003) (settled order); *In the Matter of Gary L. Hamby and Gary B. Ross*, Investment Advisers Act Release No. 1668 (Sept. 22, 1997) (settled order).

72 *See* CFA Institute Letter; Lininger Letter; NAPFA Letter; NRS Letter.

73 *See* NAPFA Letter.

relevant to most clients, regardless of whether they use one strategy or many strategies. We have, therefore, modified the item to require that advisers explain the material risks involved for each *significant* investment strategy or method of analysis they use, rather than those they *primarily* use, as we believe this threshold for disclosure better captures those methods of analysis or strategies that will be relevant to most clients.[74] However, as we noted in the proposal, the brochure may not always be the best place for a multi-strategy adviser to disclose risks associated with all of its methods of analysis or strategies.[75] Disclosure of that information likely would lengthen the brochure unnecessarily given that different clients will be pursuing different strategies, each of which poses specific and different risks.

Some commenters urged us to define the term "frequent trading of securities," which is used in Item 8.B, but did not suggest a definition in response to our request.[76] As commenters implicitly acknowledged, the phrase "frequent trading" is hard to define. We would expect advisers to respond to this item only if their intended investment strategies involve frequent trading of securities that a reasonable client would otherwise not expect in light of the other disclosures contained in the brochure.

Several commenters urged us to not require disclosure in the brochure of cash balance practices, arguing that such practices vary widely depending on the client, are typically addressed in the client's investment advisory agreement, and typically do not involve conflicts of interest.[77] We acknowledge that in many instances such practices do not involve conflicts of

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74 For these purposes, we would view a method of analysis or strategy as significant if more than a small portion of the adviser's clients' assets are advised using the method or strategy.

75 *See* Proposing Release at Section II.A.2.

76 *See* comment letter of Gary D. Case (May 12, 2008) ("Case Letter"); FSI Letter; IAA Letter; comment letter of ProEquities, Inc. (May 21, 2008) ("ProEquities Letter"); comment letter of the Trust Advisory Group (May 12, 2008) ("TAG Letter"); T. Rowe Price Letter.

77 *See* ASG Letter; IAA Letter; T. Rowe Letter.

interest and have omitted the requirement from Part 2A. We note, however, that an adviser may have an obligation (independent of Part 2A) to disclose material information about its policies regarding the management of cash balances where the omission of such information would constitute a breach of the adviser's fiduciary duty (*e.g.*, where the cash is not managed in the best interest of the client).[78]

One commenter noted that, as proposed, Items 8.B and 8.C would require disclosure of all risks associated with using a particular investment strategy or primarily recommending a particular type of security, and not just material risks.[79] We intended these items to require disclosure only of material risks, and have amended these items accordingly.[80]

This commenter also noted that Items 8.B and 8.C call for detailed discussions of "significant or unusual" risks, inquired whether this differed from "material" risks, and asked for clarification of this terminology. This requirement is intended to elicit from the adviser disclosure of significant risks associated with using a particular investment strategy or recommending a particular type of security that otherwise would not be apparent to the client from reading the adviser's brochure. An adviser that describes a wide range of investment advisory activities in its brochure but, in fact, specializes, for example, in investing in leveraged exchange-traded funds should disclose such information in response to this item.

<u>Item 9. Disciplinary Information</u>. Item 9 requires that an adviser disclose in its brochure material facts about any legal or disciplinary event that is material to a client's (or prospective client's) evaluation of the integrity of the adviser or its management personnel. These

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78 An adviser that is also registered as a broker-dealer may also have disclosure obligations relating to its cash balance practices arising under Commission and self-regulatory organization requirements. *See* NYSE information Memo No. 05-11 (Customer Account Sweeps to Banks) (Feb. 2005).

79 *See* Schnase Letter.

80 *See* Items 8.B and 8.C of Part 2A (requiring disclosure of "material risks").

requirements incorporate into the brochure the client disclosure regarding disciplinary information required by rule 206(4)-4 under the Advisers Act.

Items 9.A, B, and C provide a list of disciplinary events that are presumptively material if they occurred in the previous 10 years. Item 9 cautions advisers, however, that the events listed in that item are those that are presumed to be material and do not constitute an exhaustive list of material disciplinary events. The list includes any convictions for theft, fraud, bribery, perjury, forgery, counterfeiting, extortion and violations of securities laws by the adviser or one of its executives. Events such as these reflect on the integrity of the adviser and its management personnel and, therefore, are presumptively material to clients. The adviser may rebut this presumption, in which case no disclosure to clients is required.[81] An adviser rebutting this presumption must document its determination in a memorandum and retain that record to enable our staff to monitor compliance with this important disclosure requirement.[82]

As required by rule 206(4)-4, Item 9 requires that disciplinary events more than 10 years old be disclosed if the event is so serious that it remains material to a client's or prospective client's evaluation of the adviser and the integrity of its management. Three commenters requested that the Commission further define and clarify what disciplinary information is material in these circumstances.[83] We have determined not to do so, however, as advisers should evaluate their obligations to disclose information to clients under existing materiality standards adopted by the courts and the Commission.[84] We note that a prior disciplinary event

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[81] Note to Item 9 of Part 2A (explaining four factors an adviser should consider when assessing whether the presumption can be rebutted).

[82] Rule 204-2(a)(14)(iii).

[83] *See* AICPA Letter; Sutherland Letter; Jackson Letter.

[84] *See supra* note 35 for a discussion of materiality under the Advisers Act. *See also* the note at the end of Item 9 of Part 2A and *Financial and Disciplinary Information that Investment Advisers*

involving an adviser would be important to clients for many reasons, including how it may reflect upon the adviser's integrity, the effect it may have on the degree of trust and confidence a client would place in the adviser, or if it imposed limitations on an adviser's activities.[85]

Two other commenters addressed the rebuttable presumption of materiality under Item 9.[86] One commenter supported the flexibility of allowing advisers to rebut the presumption of materiality.[87] Other commenters suggested, however, that an adviser should not be permitted to rebut this presumption, stating that this would give advisers little incentive to disclose disciplinary information that may be considered material.[88] We note that an adviser, as a fiduciary, has an obligation to disclose material information to clients.[89] We believe that the legal consequences that flow from its failure to meet this obligation provide an incentive for an adviser to disclose material disciplinary information. Moreover, advisers that seek to exclude information from their brochures because they believe that they can rebut the presumption of

Must Disclose to Clients, Investment Advisers Act Release No. 1035 (Sept. 19, 1986) [51 FR 34229 (Sept. 26, 1986)](" Rule 206(4)-4 Proposing Release"), at nn.12-13 and accompanying text. One commenter noted the use of the term "currently material" in Item 9 and asked if this phrase differed in meaning from "material." *See* ABA Committees Letter. We did not intend this phrase to have a different meaning than "material" and, therefore, we have deleted the word "currently" in the Item 9 as adopted.

85 *See* Rule 206(4)-4 Proposing Release, at nn.12-13 and accompanying text. The Commission has long viewed information about a prior disciplinary proceeding involving an adviser as important to clients and that failure to disclose such a proceeding may violate the antifraud provisions of sections 206(1) and 206(2) of the Advisers Act. *See e.g.*, *In the Matter of Jesse Rosenblum*, Investment Advisers Act Release No. 913 (May 17, 1984).

86 *See* Morgan Stanley Letter; Sutherland Letter.

87 *See* IAA Letter.

88 *See* NASAA Letter; NCS Letter.

89 We note that failure to disclose material information to clients constitutes a violation of section 206 of the Advisers Act. We have brought enforcement actions charging advisers with failures to make such disclosures. *See, e.g., Colley Asset Management, Inc., and John E. Colley*, Investment Advisers Act Release No. 2363 (Feb. 25, 2005) (settled order).

materiality must memorialize the basis for that determination, which is subject to review by our staff.[90]

In the Proposing Release, we requested comment on whether we should require disclosure about arbitration awards and claims.[91] A few commenters supported arbitration disclosure, arguing that investors deserve the most complete information available to build a picture of an adviser's integrity.[92] Others objected, with some reasoning that arbitration claims are easy to make and that arbitration settlements and awards may not necessarily include findings of wrongdoing (*i.e.*, parties may settle arbitration proceedings and/or arbitration awards may be granted even in the absence of legal violations).[93] For this reason, we have determined not to require disclosure of arbitration awards in the client brochure. Advisers should, however, carefully consider whether particular arbitration awards or settlements do, in fact, involve or implicate wrongdoing and/or reflect on the integrity of the adviser, and should be disclosed to clients in the brochure or through other means.[94] Because many disputes involving securities firms (including investment advisers) are resolved through arbitration or other methods of

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[90] We also note that an adviser is required in Part 1A of Form ADV to disclose disciplinary events regardless of whether they are material. Part 1A is filed electronically with the Commission and is publicly available on our website.

[91] *See* Proposing Release at Section II.A.2. We also requested comment in the Proposing Release on whether we should require that advisers subject to a Commission administrative order provide clients with a copy of that order. Commenters did not support such a requirement and stated that, when appropriate, we should require delivery of orders in individual proceedings. *See* Federated Letter; Fried Frank Letter; Morgan Stanley Letter; Sutherland Letter. We agree with commenters and Part 2A does not require that such orders be provided to advisory clients.

[92] *See* Consumer Federation Letter; CFA Institute Letter; CFP Board Letter; NASAA Letter.

[93] *See* comment letter from Michael Berlin (Apr. 28, 2008) ("Berlin Letter"); Federated Letter; First Allied Letter; Fried Frank Letter; IAA Letter; ICI Letter; Janus Letter; Mercer Letter; Morgan Stanley Letter; NRS Letter; SIFMA Letter; comment letter of R.C. Verbeck (May 12, 2008) ("Verbeck Letter").

[94] We note that failure to disclose material information to clients constitutes a violation of section 206 of the Advisers Act.

alternative dispute resolution, we will continue to assess whether we should require that these events be reported by firms registered with us.

Item 9 requires that an adviser must disclose if it (or any of its management persons) has been *involved* in one of the events listed in that item. "Involved" is defined as "[e]ngaging in any act or omission, aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act."[95] Three commenters requested that we narrow the definition of "involved," arguing that the proposed definition is both overbroad and vague.[96] Other commenters supported using the term "involved," as defined.[97] One of these commenters noted that this term also is used in Form BD and in Form U4 and, as such, changing the meaning of the term (or eliminating it from Part 2A) would undermine uniformity and create disparate reporting between broker-dealers and advisers.[98] We believe that, for purposes of consistency, it is appropriate to continue to define the term "involved" as currently defined in Form ADV. This term and definition has been used in Form ADV for over 9 years and on Form BD for over 14 years, and we believe its meaning should be well understood.[99]

Some commenters recommended that advisers be permitted to satisfy the obligation to disclose and update disciplinary events by referring clients to the Investment Adviser Public Disclosure system (IAPD) to obtain the firm's disclosures from Part 1A of Form ADV and

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95 *See* the Glossary to Form ADV.

96 *See* Federated Letter; IAA Letter; Morgan Stanley Letter.

97 *See* CFA Institute Letter; NASAA Letter.

98 *See* NASAA Letter.

99 *See Amendments to Form ADV*, Investment Advisers Act Release No. 1897 (Sept. 12, 2000) [65 FR 57438 (Sept. 22, 2000)]; *Form BD Amendments*, Securities Exchange Act Release No. 37431 (July 12, 1996) [61 FR 37357 (July 18, 1996)].

providing a copy of the disciplinary disclosures to clients who do not have Internet access.[100] One commenter strongly opposed this recommendation, however, stating that "[a]rming investors with this information is one of the best tools we have to put investors on their guard so that they can protect their own interests."[101]

The disciplinary information provided in Part 1A is provided to the Commission primarily for registration purposes and not with an eye towards client disclosure. Part 1A, therefore, requires disclosure not just about the advisory firm and its management personnel, but also about all of its "advisory affiliates." A firm's advisory affiliates include all of the firm's employees, officers, partners, or directors and all persons directly or indirectly controlling or controlled by the firm.[102] Having disciplinary information about this broad group is important to the Commission for regulatory purposes. However, many of the largest investment advisers may have a large number of advisory affiliates and voluminous disciplinary disclosure, much of which may be regarding advisory affiliates with no relationship to particular clients. Accordingly, we believe that requiring clients to sift through an advisory firm's Part 1A disciplinary disclosure is not the most effective *client* disclosure. Therefore, we are adopting the proposed requirement that the brochure affirmatively disclose disciplinary information about the adviser and its management personnel.

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[100] *See* comment letter of the Alternative Investment Management Association (May 16, 2008) ("AIMA Letter"); ASG Letter; Janus Letter; Morgan Stanley Letter; NRS Letter; SIFMA Letter; Sutherland Letter.

[101] Consumer Federation Letter.

[102] *See* Form ADV: Glossary. Firm employees that perform only clerical, administrative, support, or similar functions are excluded from the definition.

Because Part 2A, as amended, incorporates disciplinary disclosures formerly required by rule 206(4)-4 directly in the advisory brochure requirements, we are rescinding rule 206(4)-4.[103] The rescission of rule 206(4)-4 will be effective, with respect to any particular investment adviser, on the date by which that adviser must deliver its narrative brochure to existing clients and begin delivering its brochure to prospective clients under the rule and form amendments we are adopting today.[104] Some advisers, however, may have clients to whom they are not required to deliver a brochure, such as certain clients receiving only impersonal investment advice or those that are registered investment companies and business development companies.[105] For these advisers, their fiduciary duty of full and fair disclosure requires them to continue to disclose to *all* their clients material disciplinary and legal events and their inability to meet contractual commitments to their clients.[106]

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103 In addition to requiring disclosure of certain disciplinary information, rule 206(4)-4 requires an adviser to disclose certain financial information to clients. As with the disciplinary disclosure, we have incorporated this requirement into the new brochure. Similar to rule 206(4)-4(a)(1), Item 18.B of Part 2A requires certain advisers to disclose any financial condition that is reasonably likely to impair their ability to meet contractual commitments to clients. *See infra* note 177 and accompanying text.

104 *See infra* Section V.

105 Our requirements regarding to which clients an adviser must deliver a brochure are discussed in Section II.A.3 below. One commenter suggested that we retain rule 206(4)-4 to require only the delivery of disciplinary information to clients for whom the brochure delivery requirement does not apply. *See* ABA Committees Letter.

106 *See Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients*, Investment Advisers Act Release No. 1035 (Sept. 19, 1986) ("Rule 206(4)-4 Adopting Release") ("explaining that rule 206(4)-4 was designed to codify an investment adviser's fiduciary obligation to disclose material financial and disciplinary information to clients."). We have brought enforcement actions charging advisers with failures to make such disclosures. *See, e.g.*, *In the Matter of Veritas Financial Advisors LLC, Veritas Advisors, Inc., Patrick J. Cox and Rita A. White*, Investment Advisers Act Release No. 2577 (Dec. 29, 2006) (settled order); *In the Matter of Harry Michael Schwartz*, Investment Advisers Act Release No. 1833 (Sept. 27, 1999) (settled order); *In the Matter of Renaissance Capital Advisors, Inc., and Richard N. Fine*, Investment Advisers Act Release No. 1688 (Dec. 22, 1997) (settled order). In addition, under section 9(a) of the Company Act [15 USC 80a-9(a)] an investment adviser to a registered investment company may be prohibited from serving in certain capacities with the fund as a result of a disciplinary event.

Item 10. Other Financial Industry Activities and Affiliations. Item 10 requires each adviser to describe in its brochure material relationships or arrangements the adviser (or any of its management persons) has with related financial industry participants, any material conflicts of interest that these relationships or arrangements create, and how the adviser addresses the conflicts.[107] In addition, if an adviser selects or recommends other advisers for clients, Item 10 requires that it disclose any compensation arrangements or other business relationships between the advisory firms, along with the conflicts created, and explain how it addresses these conflicts.[108] The disclosure that Item 10 requires highlights for clients their adviser's other financial industry activities and affiliations that can create conflicts of interest and may impair the objectivity of the adviser's investment advice.

Two commenters explicitly stated that they supported the disclosure required by this item.[109] At the suggestion of one commenter,[110] we have modified Item 10.D to require advisers that recommend other advisers to disclose, in particular, payments or business relationships *that create material conflicts of interest* with clients, so as not to capture all relationships.

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[107] This item is similar to Item 8 of the previous Part 2. Two commenters requested that we clarify or provide guidance regarding "materiality" in describing relations and arrangements with related persons, and conflicts of interest arising from these relations or arrangements. *See* IAA Letter; NRS Letter. We address this comment earlier in this Release. *See supra* note 35 for a further discussion of materiality under the Advisers Act.

[108] We have brought enforcement actions charging advisers with failures to make such disclosures. *See, e.g.*, *In the Matter of Morgan Stanley & Co., Incorporated*, Investment Advisers Act Release No. 2904 (July 20, 2009) (settled order); *In the Matter of Yanni Partners, Inc. and Theresa A. Scotti*, Investment Advisers Act Release No. 2642 (Sept. 5, 2007) (settled order).

[109] *See* CFA Institute Letter; Lininger Letter.

[110] *See* Sutherland Letter.

Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.

Code of Ethics. Item 11 requires each adviser to describe briefly its code of ethics and state that a copy is available upon request.[111] Two commenters strongly supported the proposed item, believing the required disclosure is indicative of an adviser's commitment to its fiduciary duties.[112] One recommended that we instead simply require an adviser to note in the brochure that a copy of its code of ethics is available upon request.[113] We believe that a brief, concise summary of the code of ethics (as the item requires) will be helpful to prospective clients who may not wish or feel the need to request the entire code of ethics and will assist those clients in determining whether they would like to read the entire code of ethics.[114]

Participation or Interest in Client Transactions. If the adviser or a related person recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, Item 11.B requires the brochure to discuss this practice and the conflicts of interest presented.[115] Conflicts could arise, for example, when an adviser recommends that clients invest in a pooled investment vehicle that the firm advises or for

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111 This requirement is almost identical to the previous disclosure requirement in Item 9 of the previous Part 2.

112 *See* CFA Institute Letter; CFP Board Letter.

113 *See* Morgan Stanley Letter.

114 This summary should not be a reiteration of the entire code of ethics, but rather should provide enough information for the client to determine if it would like to read the full code of ethics and to understand generally the adviser's ethical culture and standards, how the adviser controls sensitive information, and what steps it has taken to prevent employees from misusing their inside positions at clients' expense. *See Investment Adviser Code of Ethics*, Investment Advisers Act Release No. 2256 (July 2, 2004), at text accompanying notes nn.66-67 [69 FR 41696 (July 9, 2004)].

115 An adviser's related persons are: (1) the adviser's officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly controlling, controlled by, or under common control with the adviser; (3) all of the adviser's current employees; and (4) any person providing investment advice on the adviser's behalf. *See* Form ADV: Glossary. Items 11.B, 11.C, and 11.D are similar to Item 9 of the previous Part 2.

which it serves as the general partner,[116] or when an adviser with a material financial interest in a company recommends that a client buy shares of that company.[117] The item requires advisers to disclose any practices giving rise to these conflicts, the nature of the conflicts presented, and how the adviser addresses the conflicts. Two commenters expressed support for this requirement.[118] We are adopting Item 11.B. substantially as proposed, except that at the suggestion of three commenters, we have omitted the portion of the proposed item that required advisers to disclose "procedures" for making the disclosures to clients.[119] We agree with these commenters that the requirement was inconsistent with the Commission's general approach throughout the brochure of requiring disclosure about conflicts and how they are addressed, but not about "procedures."

Personal Trading. Items 11.C and 11.D require disclosure of personal trading by the adviser and its personnel.[120] Item 11.C requires an adviser to disclose whether it or a related person (*e.g.*, advisory personnel) invests (or is permitted to invest) in the same securities that it recommends to clients, or in related securities (such as options or other derivatives). If so, the brochure must discuss the conflicts presented and describe how the firm addresses the conflicts. Item 11.D requires a similar discussion, but focuses on the specific conflicts an adviser has when

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116 We have brought enforcement actions charging advisers with failures to make such disclosures. *See, e.g., In the Matter of Thomson McKinnon Asset Management, L.P.*, Investment Advisers Act Release No. 1243 (July 26, 1990) (settled order).

117 We have brought enforcement actions charging advisers with failures to make such disclosures. *See, e.g., In the Matter of Chancellor Capital Management, Inc., et al.*, Investment Advisers Act Release No. 1447 (Oct. 18, 1994) (settled order).

118 *See* CFA Institute Letter; CFP Board Letter.

119 *See* IAA Letter; ICI Letter; T. Rowe Letter.

120 We have brought enforcement actions charging advisers with fraudulent personal trading. *See In the Matter of Roger W. Honour*, Investment Advisers Act Release No. 1527 (Sept. 29, 1995) (settled order).

it or a related person trades in the same securities at or about the *same time* as a client.[121] In response to this item, an adviser should explain how its internal controls, including its code of ethics, prevent the firm and its staff from buying or selling securities contemporaneously with client transactions.

One commenter suggested that we specify a minimum amount of assets that must be managed by an adviser in order for that adviser to be required to disclose personal securities transactions, arguing that small firms' securities transactions are not large enough to generate a market impact and thus should not require disclosure.[122] We disagree. A small firm could still place a trade large enough to have a market impact, especially in a thinly traded security. In addition, given that an adviser's ability to place its own trades before or after client trades in the same security may affect the objectivity of the adviser's recommendations, we believe disclosure of this practice is warranted. As a result, we are adopting Items 11.C and 11.D as proposed.

Finally, we note that we have modified the note to Item 11 to clarify that Items 11.B, 11.C, and 11.D would not require disclosure with respect to securities that are not "reportable securities" under Advisers Act rule 204A-1(e)(10), such as shares in unaffiliated mutual funds.[123] As we indicated in the Proposing Release, such securities are not reportable under Advisers Act Rule 204A-1 because they appear to present little opportunity for front-running.[124]

Item 12. Brokerage Practices. Item 12 requires that advisers describe how they select brokers for client transactions and determine the reasonableness of brokers' compensation. This

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121 We have brought enforcement actions charging advisers with inaccurate disclosure in this context. *See, e.g.*, *In the Matter of Hutchens Investment Management and William Hutchens*, Investment Advisers Act Release No. 2514 (May 9, 2006) (settled order).

122 *See* comment letter of Thaddeus Borek, Jr. (May 16, 2008).

123 *See* Code of Ethics Adopting Release, *supra* note 114 at n.42 and accompanying text.

124 *See* Proposing Release, *supra* note 2, at n.85.

item also requires advisers to disclose how they address conflicts of interest arising from their receipt of soft dollar benefits (*i.e.*, research or other products or services they receive in connection with client brokerage).[125]

Soft Dollar Practices. Many advisers receive brokerage and research services in reliance on section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"),[126] as well as other soft dollar products and services provided by brokers in connection with client transactions.[127] Use of client securities transactions to obtain research and other benefits creates incentives that result in conflicts of interest between advisers and their clients.[128] Because of these conflicts, we have long required advisers to disclose their policies and practices with respect to their receipt of soft dollar benefits in connection with client securities transactions.[129]

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125 Item 12 is similar to Item 12.B in the previous Part 2.

126 Section 28(e) of the Exchange Act provides a limited "safe harbor" for advisers with discretionary authority in connection with their receipt of soft dollar benefits. Under section 28(e), a person who exercises investment discretion over a client account has not acted unlawfully or breached a fiduciary duty *solely* by causing the account to pay more than the lowest commission rate available, so long as that person determines in good faith that the commission amount is reasonable in relation to the value of the brokerage and research services provided. Advisers must disclose their receipt of soft dollar benefits to clients, regardless of whether the benefits fall inside or outside of the safe harbor. *See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Release No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1986)], at n.33 and accompanying text.

127 According to IARD data as of May 3, 2010, approximately 61% of advisers registered with the Commission report on Form ADV, Part 1A, Item 8.E that they or related persons receive soft dollar benefits in connection with client transactions.

128 *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 54165 (July 18, 2006) [71 FR 41978 (July 24, 2006)] ("2006 Soft Dollar Release") ("[u]se of client commissions to pay for research and brokerage services presents money managers with significant conflicts of interest, and may give incentives for managers to disregard their best execution obligations when directing orders to obtain client commission services as well as to trade client securities inappropriately in order to earn credits for client commission services").

129 *See* Item 12 of the previous Part 2.

Item 12 requires an adviser that receives soft dollar benefits in connection with client securities transactions to disclose its practices.[130] The description must be specific enough for clients and prospective clients to understand the types of products or services the adviser is acquiring and permit them to evaluate associated conflicts of interest. Disclosure must be more detailed for products or services that do not qualify for the safe harbor in section 28(e) of the Exchange Act, such as services that do not aid in the adviser's investment decision-making process.[131]

Item 12 also requires that an adviser discuss in its brochure the types of conflicts it has when it accepts soft dollar benefits and explain how it addresses those conflicts.[132] The item requires the adviser to explain whether it uses soft dollars to benefit all client accounts or only those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionately to the soft dollar credits those accounts generate. The item also requires the adviser to explain whether it "pays up" for soft dollar benefits.[133]

Some commenters, including one association representing more than 130 pension funds, expressed their strong support for the soft dollar disclosure requirement.[134] Other commenters

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130 *See* Item 12.A.1 of Part 2A.

131 *See* note to Item 12.A.1.e of Part 2A.

132 *See* Item 12.A.1. An adviser accepting soft dollar benefits must explain that (a) the adviser benefits because it does not have to produce or pay for the research or other products or services acquired with soft dollars, and (b) the adviser therefore has an incentive to select or recommend brokers based on the adviser's interest in receiving these benefits, rather than on the client's interest in getting the most favorable execution. *See* Item 12.A.1.a and b of Part 2A.

133 "Paying up" refers to an adviser causing a client account to pay more than the lowest available commission rate in exchange for soft dollar products or services.

134 *See* comment letter of the Council of Institutional Investors (May 16, 2008) ("CII Letter"); CFA Institute Letter; NRS Letter; comment letter of Carolina Capital Markets, Inc. (Aug. 8, 2008).

objected to various portions of this item.[135] Some of these commenters recommended elimination of the proposed requirements to disclose whether an adviser allocates soft dollar benefits to client accounts proportionately to the brokerage credits those accounts generate,[136] and to disclose the "procedures" it uses to direct client transactions to a particular broker-dealer.[137] Some of these commenters also questioned the conflicts we identified and expressed concern that the item will tend to create a misleading impression that the use of soft dollar arrangements is harmful.[138]

There are significant conflicts associated with soft dollar arrangements. Section 28(e) was enacted, in part, to address them.[139] We are not taking a view on the propriety of soft dollar arrangements, but rather are requiring full disclosure of arrangements that involve significant conflicts of interest.[140] Moreover, disclosure required by Item 12 is similar to disclosure requirements previously required in Part 2 of Form ADV.[141] We are adopting this requirement as proposed.

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135 *See, e.g.*, comment letter of the Alliance in Support of Independent Research (May 16, 2008) ("Alliance Letter"); CAPIS Letter; IAA Letter; ICI Letter; comment letter of Pickard and Djinis LLP (May 14, 2008) ("Pickard Letter"); SIFMA Letter; T. Rowe Letter.

136 *See* Alliance Letter; CAPIS Letter; IAA Letter; ICI Letter; Pickard Letter.

137 *See* Alliance Letter; CAPIS Letter; IAA Letter; ICI Letter.

138 *See* Alliance Letter; IAA Letter; ICI Letter; SIFMA Letter.

139 *See* 2006 Soft Dollar Release, *supra* note 128, at nn.4-6 and accompanying text.

140 We have brought enforcement actions charging advisers with not adequately disclosing soft dollar arrangements and related conflicts. *See, e.g.*, *In the Matter of Schultze Asset Management LLC and George J. Schultze*, Investment Advisers Act Release No. 2633 (Aug. 15, 2007) (settled order); *In the Matter of Rudney Associates, Inc. et al.*, Investment Advisers Act Release No. 2300 (Sept. 21, 2004) (settled order).

141 Item 12.B. of the previous Part 2 required, for example, that the adviser describe the factors considered in selecting brokers and determining the reasonableness of their commissions. In addition, if the value of products, research and services given to the adviser is a factor in selecting brokers, the adviser was required to, among other things, describe whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services.

Client Referrals. If an adviser uses client brokerage to compensate or otherwise reward brokers for client referrals, it also must disclose this practice, the conflicts of interest it creates, and any procedures the adviser used to direct client brokerage to referring brokers during the last fiscal year (*i.e.*, the system of controls used by the adviser when allocating brokerage).[142] Part 2 previously required that advisers disclose these arrangements, but did not specifically require that the description discuss the conflicts of interest created.[143] We did not receive any comments relating to this item and are adopting the requirement as it was proposed so that clients are aware that their adviser may have a bias toward referring brokers, a significant conflict of interest.[144]

Directed Brokerage. Item 12 requires an adviser that permits clients to direct brokerage to describe its practices in this area. Item 12 also requires that such an adviser explain that it may be unable to obtain the most favorable execution of client transactions if the client directs brokerage and that directing brokerage may be more costly for clients.[145] If, however, an adviser *routinely recommends, requests or requires* clients to direct brokerage, Item 12 also requires the adviser to describe this practice in its brochure, to disclose that not all advisers require directed brokerage, and to describe any relationship with a broker-dealer to which the brokerage may be

142 Item 12.A.2 of Part 2A.

143 *See* Item 13.B. of the previous Part 2.

144 We have brought enforcement actions charging advisers with failing to disclose to clients that they directed their brokerage commissions in return for client referrals. *See, e.g.*, *In the Matter of Fleet Investment Advisors, Inc.*, Investment Advisers Act Release No. 1821 (Sept. 9, 1999) (settled order).

145 *See* Item 12.A.3.b of Part 2A. As we discussed in the Proposing Release, clients sometimes instruct their adviser to send transactions to a specific broker-dealer for execution. Clients may initiate this type of arrangement for a variety of reasons, such as favoring a family member or friend or compensating the broker-dealer indirectly for services it provides to the client. But the arrangement also may be initiated by the adviser, who may benefit, for example, when brokerage is directed to its affiliated broker-dealer. In either case, clients directing (or agreeing to direct) brokerage need to understand the consequences of directing brokerage, including the possibility that their accounts will pay higher commissions and receive less favorable execution.

directed that creates a material conflict of interest.[146] An adviser may omit disclosure regarding its inability to obtain best execution if directed brokerage arrangements are only conducted subject to the adviser's ability to obtain best execution.[147]

Two commenters addressed this requirement. One, representing pension funds, endorsed our proposal as supporting transparency in brokerage arrangements.[148] The other urged that we broaden the proposed exception in the item to all directed brokerage subject to best execution, whether recommended by the adviser or directed by the client. The commenter pointed out that such client-imposed limitations on direction of brokerage should address the Commission's concerns in proposing the item.[149] We agree, and have revised the note following the item accordingly.

Trade Aggregation. Clients engaging an adviser can benefit when the adviser aggregates trades to obtain volume discounts on execution costs. Item 12 requires the adviser to describe whether and under what conditions it aggregates trades. If the adviser does not aggregate trades when it has the opportunity to do so, the adviser must explain in the brochure that clients may therefore pay higher brokerage costs. One commenter supported this disclosure, stating that it is helpful and meaningful to clients.[150] However, another commenter expressed concern that such disclosure would suggest that advisers should always aggregate orders, and noted that there are circumstances where an adviser may decide that it is better for the client not to do so, such as

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146 *See* Item 12.A.3.a of Part 2A. We have brought enforcement actions charging advisers with failures to make such disclosures. *See also In the Matter of Callan Associates*, Investment Advisers Act Release No. 2650 (Sept. 19, 2007) (settled order); *In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisers Act Release No. 2129 (May 15, 2003) (settled order).

147 *See* note to Item 12.A.2 of Part 2A.

148 *See* CII Letter.

149 *See* Alliance Letter.

150 *See* NRS Letter.

with multiple large trades that may create a market impact.[151] Other commenters argued that trade aggregation practices are not material to clients.[152] But aggregation practices may have a material effect on the quality of execution. Thus, we believe that such practices should be disclosed in the brochure.

Finally, one commenter suggested deleting the words "in quantities sufficient to obtain reduced transaction costs" from the first sentence of Item 12.B since there may be other circumstances in which advisers may aggregate client trades that should be disclosed to clients.[153] As this item was intended to require advisers to explain their aggregation practices along with the reasons for and consequences of those practices more generally, we have removed this limiting phrase.

Item 13. Review of Accounts. Item 13 requires that an adviser disclose whether, and how often, it reviews clients' accounts or financial plans, and identify who conducts the review.[154] An adviser that reviews accounts other than regularly must explain what circumstances trigger an account review.

Three commenters addressed this item. One supported it as being helpful to clients.[155] Two thought that this item provided non-critical information that could be eliminated in the interest of providing a shorter brochure to clients.[156] We believe the disclosure, which can be

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151 *See* IAA Letter.

152 *See* Fried Frank Letter.

153 *See* Schnase Letter.

154 Item 13 is similar to Item 11 in the previous Part 2.

155 *See* CFA Institute Letter.

156 *See* SIFMA Letter; Sutherland Letter.

brief, provides very useful information to clients about their advisers' management of their accounts. As a result, we are adopting this item substantially as it was proposed.[157]

Item 14. Client Referrals and Other Compensation. Item 14 requires an adviser to describe in its brochure any arrangement under which it or its related person compensates another for client referrals and describe the compensation. The brochure also must disclose any arrangement under which the adviser receives any economic benefit, including sales awards or prizes, from a person who is not a client for providing advisory services to clients.[158]

We received three comments on this item. One supported the proposed item, stating that these areas involve practices that raise conflicts of interest.[159] Another suggested that it be omitted because certain disclosure required under this item is already required by rule 206(4)-3 under the Advisers Act (the "cash solicitation rule").[160] The cash solicitation rule, however, applies only to certain types of payments and requires disclosure by the solicitor rather than the adviser.[161] Finally, one commenter urged that we amend the Item to disclose the conflicts of

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157 The Schnase Letter suggested changing the word "employee" in Item 13.A to "supervised person." As defined in the Form ADV Glossary, "supervised person" means "any of your officers, partners, directors (or other persons occupying a similar status or performing similar functions), or employees, or any other person who provides investment advice on your behalf and is subject to your supervision or control." For purposes of consistency throughout Part 2A, we are making the change suggested by the commenter. We also are substituting the word "supervised person" for the word "employee" in Item 14.B, Instruction 6 for Part 2A, Appendix 1 (the wrap fee program brochure), and Item 6.C of Part 2A, Appendix 1.

158 Similar disclosure was previously required by Item 13 of Part 2.

159 *See* CFA Institute Letter.

160 *See* Sutherland Letter.

161 Rule 206(4)-3 applies to advisers paying *cash* referral fees to solicitors, and thus does not require disclosure of non-cash benefits. The rule requires, among other things, that an unaffiliated solicitor provide the adviser's brochure and a separate disclosure document described in the rule to clients or prospective clients at the time of any solicitation activities. *See* rule 206(4)-3(a)(2)(iii).

interest associated with these arrangements.[162] We agree. There are significant conflicts of interest when an adviser receives benefits from a third party for providing advisory services to a client, or when an adviser pays a third party for client referrals. We are revising Item 14.A from our proposal to require an adviser that accepts benefits from a non-client for providing advisory services to clients describe the arrangement, any conflicts of interests that arise from the arrangement, and how the adviser addresses those conflicts.

- Item 15. Custody. Item 15 requires an adviser with custody of client funds or securities to explain in its brochure that clients will receive account statements directly from the qualified custodian, such as a bank or broker-dealer that maintains those assets. Advisers must also explain to clients that they should carefully review the account statements they receive from the qualified custodian. In addition, if an adviser also sends clients account statements, the adviser's explanation must include a statement urging clients to compare the account statements they receive from the qualified custodian with those they receive from the adviser. Comparing statements will allow clients to determine whether account transactions, including deductions to pay advisory fees, are proper. This disclosure is very similar to the statement required to be made by advisers under our recently amended custody rule.[163]

We proposed an alternative disclosure requirement in Item 15 that we are not adopting today. Proposed Item 15.A. would have required that, if clients did not receive account statements from qualified custodians, the adviser must disclose the risks that clients would face

162 *See* Schnase Letter. This commenter also suggested that we rename this item since Item 14.B relates only to payment for client referrals. In light of this comment, we are renaming this item "Client Referrals and Other Compensation."

163 *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1456 (Jan. 11, 2010)] ("Custody Rule Adopting Release") at section II.A.

as a result.[164] This alternative is no longer relevant because the amendments to the custody rule eliminated the option that permitted advisers to substitute their own account statements for those from a qualified custodian.[165]

Item 16. Investment Discretion. Item 16 requires an adviser with discretionary authority over client accounts to disclose this fact in its brochure,[166] and any limitations clients may (or customarily do) place on this authority.[167] Two commenters suggested that the Commission not require advisers to provide duplicative disclosure regarding discretionary authority as it likely would be incorporated into the description of the advisory business in Item 4.[168] We note that if the information is provided in response to Item 4, the adviser may cross-reference the information. We therefore are adopting this item as proposed.

Item 17. Voting Client Securities. Item 17 requires advisers to disclose their proxy voting practices. This item parallels rule 206(4)-6 under the Advisers Act, which, among other things, requires advisers registered with the Commission to disclose certain information about their proxy voting practices.[169] Item 17 also requires advisers to disclose whether they have or will accept authority to vote client securities and, if so, to describe briefly the voting policies

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164 *Id.* We received two comments on proposed Item 15.A. *See* ICI Letter; ABA Committee Letter.

165 Custody Rule Adopting Release, *see supra* note 163.

166 An adviser has "discretionary authority" if it is authorized to make purchase and sale decisions for client accounts. *See* Form ADV Glossary. This definition of discretionary authority is derived from section 3(a)(35) of the Exchange Act [15 U.S.C. 78c(a)(35)]. An adviser also has discretionary authority if it is authorized to select other advisers for the client. This Item is similar to Item 12.A of the previous Part 2.

167 For example, clients may not understand that they may ask the adviser not to invest in securities of particular issuers.

168 *See* IAA Letter; Sutherland Letter. They argued that such information would already be disclosed under Items 4.B, 4.C and 4.E (advisory business) or Item 8 (strategies and risks).

169 Proxy Voting Release, *see supra* note 3. Rule 206(4)-6 requires advisers to adopt and implement written voting policies and procedures. Advisers also are required to keep certain records relating to their voting. Advisers that exercise voting authority over client securities must describe their voting policies and procedures to clients and furnish clients with a complete copy upon request.

they adopted under rule 206(4)-6. Each adviser must describe whether (and how) clients can direct it to vote in a particular solicitation, how the adviser addresses conflicts of interest when it votes securities, and how clients can obtain information from the adviser on how the adviser voted their securities. Item 17 also requires an adviser to explain that clients may obtain a copy of the adviser's proxy voting policies and procedures upon request. Advisers that do not accept authority to vote securities must disclose how clients receive their proxies and other solicitations.[170]

Some commenters suggested that we eliminate Item 17 in its entirety, arguing either that the required disclosure is not important to clients or that most of the information already is available in advisory contracts.[171] Others supported this disclosure requirement, noting that clients are interested in understanding the potential conflicts of interest that may arise from an adviser's proxy voting.[172] We agree that proxy voting practices and the conflicts arising from such practices are important information that should be disclosed, and note that rule 206(4)-6 independently would require the same disclosure even if we were to eliminate it from the brochure.[173] Accordingly, we are adopting Item 17, but with one modification.

We had proposed to require detailed information about an adviser's use of third-party proxy voting services and how the adviser pays for proxy voting services. Most of the commenters addressing this proposed requirement argued that the information is not relevant for

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170 If an adviser accepts proxy voting authority for some accounts but not others, the adviser should disclose the relevant information required by this Item for each type of account unless the adviser has prepared separate brochures for the other accounts.

171 *See* NAPFA Letter; Morgan Stanley Letter.

172 *See* CFA Institute Letter; CII Letter.

173 We have brought enforcement actions relating to advisers' proxy voting policies and procedures. *See, e.g.*, *In the Matter of INTECH Investment Management LLC and David E. Hurley*, Investment Advisers Act Release No. 2872 (May 7, 2009) (settled order).

most clients.[174] In light of the Commission's Concept Release on the U.S. proxy system issued on July 14, 2010, which requests comment on a wide range of questions and issues relating to proxy advisory firms,[175] we are adopting Item 17 without this requirement. Clients interested in this information may obtain it from their advisers upon request.

Item 18. Financial Information. This item requires disclosure of certain financial information about an adviser when material to clients. Specifically, an adviser that requires prepayment of fees must give clients an audited balance sheet showing the adviser's assets and liabilities at the end of its most recent fiscal year.[176] The item also requires an adviser to disclose any financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than $1,200 in fees per client and six months or more in advance.[177] For instance, disclosure may be required where a judgment or arbitration award was sufficiently large that payment of it would create such a financial condition. Under these circumstances, clients are exposed to the risk that their assets may not be properly managed — and prepaid fees may not be returned — if, for example,

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174 *See* ASG Letter; Fried Frank Letter; IAA Letter; ICI Letter; Janus Letter; Lininger Letter. A few commenters supported this disclosure. *See* CFA Institute Letter; CII Letter.

175 *Concept Release On The U.S. Proxy System,* Investment Advisers Act Release No. IA-3052 (July 14, 2010) [75 FR 42982 (July 22, 2010)].

176 As proposed, we are increasing the threshold amount from the existing threshold, $500, to $1,200 to reflect the effects of inflation, based upon the Personal Consumption Expenditures Chain-Type Price Index as published by the U.S. Department of Commerce, since we adopted Form ADV in 1979. We also are requiring, as proposed, an audited balance sheet from advisers that *solicit* clients to prepay fees over $1,200. This portion of Item 18 is similar to Item 14 in the previous Part 2.

177 This disclosure was previously required by rule 206(4)-4. In the release adopting rule 206(4)-4, we noted that a determination about what constitutes financial condition reasonably likely to impair an adviser's ability to meet contractual commitments is inherently factual in nature but will generally include insolvency or bankruptcy. *See* Rule 206(4)-4 Adopting Release, *supra* note 106 at n.6.

the adviser becomes insolvent and ceases to do business. Finally, Item 18 requires an adviser that has been the subject of a bankruptcy petition during the past ten years to disclose that fact to clients.[178] As discussed above, although we are rescinding rule 206(4)-4 we caution advisers that their fiduciary duty of full and fair disclosure may require them to continue to disclose any precarious financial condition promptly to *all* clients, even clients to whom they may not be required to deliver a brochure or amended brochure.[179]

One commenter recommended elimination of the balance sheet requirement, stating that the balance sheet gives an imperfect picture of the financial health of an adviser,[180] and another was concerned that disclosure of financial information would unduly discriminate against smaller advisers.[181] We believe that a client that becomes a creditor of an adviser because it prepays fees would want information about the adviser's condition. This information is currently required to be disclosed to clients, and commenters have not persuaded us that it should be omitted. As a result, we are adopting Item 18 as proposed.

Item 19. Index. We proposed to require that the brochure filed with us include an index of the items required by Part 2A indicating where in the brochure the adviser addresses each item. This index was intended to facilitate review by our staff for compliance with the requirements of Part 2A. As discussed above, we are now requiring advisers to provide their responses to the items in Part 2 in the same order as the items appear in the form. As a result, the

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178 This includes the obligation of an adviser that is organized as a sole proprietorship to disclose a personal bankruptcy. This requirement conforms to our view that bankruptcy generally constitutes a "financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients" requiring disclosure under rule 206(4)-4. *See* Rule 206(4)-4 Adopting Release, *supra* note 106.

179 *See supra* note 106 and accompanying text.

180 *See* Fried Frank Letter.

181 *See* Verbeck Letter.

index would be duplicative of the table of contents and is no longer necessary. We therefore are not adopting this requirement.

Part 2A Appendix 1: The Wrap Fee Program Brochure. Advisers that sponsor wrap fee programs[182] continue to be required to prepare a separate, specialized firm brochure (a "wrap fee program brochure" or "wrap brochure") for clients of the wrap fee program in lieu of the sponsor's standard brochure.[183] The items in Appendix 1 to Part 2A contain the requirements for a wrap fee program brochure, and are substantially similar to those previously in Schedule H, the separate wrap fee program brochure in previous Part 2.[184] However, we are revising the requirements of Schedule H to incorporate many of our amendments to the Part 2A firm brochure.

We also are adopting an additional disclosure requirement to the wrap fee program brochure. It requires an adviser to identify whether any of its related persons is a portfolio manager in the wrap fee program and, if so, to describe the associated conflicts. For example, an adviser may have an incentive to select a related person to participate as a portfolio manager

182 Under wrap fee programs, which also are sometimes referred to as "separately managed accounts," advisory clients pay a specified fee for investment advisory services and the execution of transactions. The advisory services may include portfolio management and/or advice concerning selection of other advisers, and the fee is not based directly upon transactions in the client's account.

183 We adopted the requirement for a separate brochure for wrap fee clients in 1994. *See Disclosure by Investment Advisers Regarding Wrap Fee Programs*, Investment Advisers Act Release No. 1411 (Apr. 19, 1994) [59 FR 21657 (Apr. 26, 1994)]. Advisers whose entire advisory business is sponsoring wrap fee programs will prepare a wrap brochure but will not be required to prepare a standard advisory firm brochure. *See* Instruction 10 of Instructions for Part 2A of Form ADV. An adviser will have to prepare both a standard firm brochure and a wrap fee program brochure if it both sponsors a wrap fee program *and* provides other types of advisory services, and will deliver both a standard and a wrap brochure to a client who receives both types of services. Wrap fee sponsors would, like other advisers, be required to provide brochure supplements to their wrap fee clients.

184 We have brought enforcement actions regarding wrap fee program disclosure. *See, e.g.*, *In re Banc of America Investment Services, Inc. and Columbia Management Advisors, LLC* (as successor in interest to Banc of America Capital Management, LLC), Investment Advisers Act Release No. 2733 (May 1, 2008) (settled order).

based on the person's affiliation with the adviser, rather than based on expertise or performance. This item requires advisers to disclose whether related person portfolio managers are subject to the same selection and review criteria as the other portfolio managers who participate in the wrap fee program and, if they are not, how they are selected and reviewed.

Two commenters requested clarification that an adviser can delegate its brochure delivery requirement to the sponsor of the wrap fee program,[185] and one of these commenters also requested clarification that the adviser could satisfy its recordkeeping obligations that evidence delivery of the brochure by such records being retained in the offices of the sponsor and not the adviser, as long as the adviser was able to provide the records to Commission staff upon request.[186] We confirm that a sponsor may deliver the adviser's brochures and maintain certain records as long as the sponsor, upon request of the Commission's staff, will produce promptly the records for the staff at the appropriate office of the adviser or the sponsor. This delegation does not relieve the adviser of its legal delivery obligation, however, and thus the adviser should take steps to assure itself that the sponsor is performing the tasks the adviser has delegated.

3. Delivery and Updating of Brochures

The Commission also is adopting amendments to rule 204-3; our rule under the Advisers Act that requires registered advisers to deliver their brochures and certain updates to clients and prospective clients.[187]

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185 *See* Federated Letter; MMI Letter.

186 *See* MMI Letter. Rules 204-2(a)(14) and 204-2(e)(1) under the Advisers Act describe advisers' recordkeeping obligations relating to brochure delivery.

187 The brochure delivery and updating obligations are the same for both a standard brochure and a wrap fee program brochure. *See* rule 204-3.

a. Delivery to Clients

Initial Delivery. Rule 204-3, as amended, requires an adviser to deliver a current brochure before or at the time it enters into an advisory contract with the client.[188] The rule does not require advisers to deliver brochures to certain advisory clients receiving only impersonal investment advice[189] or to clients that are investment companies registered under the Investment Company Act of 1940 ("Company Act").[190] As proposed, we have expanded the latter exception to cover advisers to business development companies ("BDCs") that are subject to section 15(c) of the Company Act, which requires a board of directors to request, and the adviser to furnish, information to enable the board to evaluate the terms of the proposed advisory contract.[191] Because of this safeguard, we believe that adopting an obligation for these advisers to deliver a brochure to these BDC clients is not necessary.[192] An adviser does not have to prepare (or file with us) a brochure if it does not have any clients to whom a brochure must be delivered.[193]

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188 *See* rule 204-3(b). Rule 204-3 requires a registered adviser to furnish each client and prospective client with a written disclosure statement which may be either a copy of the adviser's completed Part 2A or a written document containing the information required by Part 2A. Previously, such delivery had to occur at least 48 hours before entering into the advisory agreement, *or* at the time of entering into the agreement if the client has the right to terminate the agreement without penalty within five business days thereafter. We received two comments on this proposed change to the timing of the required initial brochure delivery, both in support. *See* Pickard Letter; T. Rowe Letter.

189 *See* rule 204-3(c)(2) and Instruction 1 for Part 2A of Form ADV. Advisers are not required to deliver brochures to advisory clients receiving only impersonal investment advice for which the adviser charges less than $500 per year. As proposed, we increased the dollar threshold triggering this exception from $200 to $500 to reflect the effects of inflation, based upon the Personal Consumption Expenditures Chain-Type Price Index, as published by the U.S. Department of Commerce, since rule 204-3 was adopted in 1979. We did not receive comments on this change.

190 *See* rule 204-3(c)(1) and Instruction 1 for Part 2A of Form ADV.

191 *See supra* note 190. As discussed above, an adviser's fiduciary duty of full and fair disclosure, however, may require it to continue to disclose any material legal event or precarious financial condition promptly to *all* clients, even clients to whom it may not be required to deliver a brochure or amended brochure. *See supra* note 106 and accompanying text.

192 Two commenters urged us to adopt an exception for "hedge funds," or clarify that advisers to hedge funds are not required to deliver copies of brochures to their investors. *See* ABA

Annual Delivery. Advisers must annually provide to each client to whom they must deliver a brochure either: (i) a copy of the current (updated) brochure that includes or is accompanied by the summary of material changes; or (ii) a summary of material changes that includes an offer to provide a copy of the current brochure.[194] As proposed, each adviser must make this annual delivery no later than 120 days after the end of its fiscal year.[195] Advisers may deliver a brochure and summary of material changes or summary of material changes, along with an offer to provide the brochure to clients electronically in accordance with the Commission's guidelines regarding electronic delivery of information.[196] An adviser that does not include, and therefore file, its summary of material changes as part of its brochure (on the cover page or the page immediately following the cover) must file its summary as an exhibit, included with its

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Committees Letter; Fried Frank Letter. We note that rule 204-3 requires only that brochures be delivered to "clients." We further note that the Court of Appeals for the D.C. Circuit stated that the "client" of an investment adviser managing a hedge fund is the fund itself, not an investor in the fund. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

193 *See* Instruction 7 for Part 2A of Form ADV.

194 *See* rule 204-3(b) and Item 2 to Part 2A of Form ADV. The offer also must be accompanied by a website address and a telephone number and e-mail address for obtaining the complete brochure pursuant to the Instructions for Part 2, as well as the website address for obtaining information about the adviser through IAPD. We also are adopting an amendment to our recordkeeping rule that will require the adviser choosing this approach to preserve a copy of the summary of material changes, so that our examination staff has access to such separately provided summaries. *See* rule 204-2(a)(14)(i). *See* Section IV below.

If an adviser includes the summary of material changes in its brochure, and amends its brochure on an interim basis between annual updating amendments, the adviser should consider whether it should update its summary of material changes to avoid confusing or misleading clients reading the updated brochure.

195 *See* Rule 204-3(b) and Instruction 2 for Part 2A of Form ADV. As discussed below, rule 204-1 requires an adviser registered with the Commission to annually revise its Form ADV, including its brochure, within 90 days of its fiscal year end. Advisers typically provide clients with reports quarterly, and the 120-day period is designed to provide sufficient flexibility to allow advisers to include the updated brochure or summary in a routine quarterly mailing to clients. We expect that permitting an adviser to send this document together with these routine mailings could substantially reduce delivery costs. *See* Section VII below.

196 *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Investment Advisers Act Release No. 1562 (May 9, 1996) [61 FR 24644 (May 15, 1996)] ("Electronic Media Release").

brochure when it files its annual updating amendment with us, so that the summary of material changes is available to the public through IAPD.[197]

We proposed that each adviser annually deliver an updated brochure to its clients because we were concerned that clients may be relying on "stale" brochures. Many commenters representing advisers objected, arguing that this requirement would cause advisers to incur significant costs,[198] and that clients are not interested in receiving an annual brochure.[199] We believe our revised approach — permitting advisers to deliver annually the summary of material changes, which was suggested by several commenters[200] — addresses our concern that clients may today be relying on "stale" brochures, while alleviating commenters' concerns regarding the costs and burdens of annual delivery of the brochure.[201]

Some commenters urged that we revise our electronic delivery guidance[202] so that disclosure placed on the adviser's web page or on IARD would be deemed to be delivered to its

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197 *See* Instruction 6 for Part 2A of Form ADV. The adviser must upload its brochure and the summary (as an exhibit) together in a single, text-searchable file in Adobe Portable Document Format (PDF) on IARD. *See* Instruction 6 for Part 2A of Form ADV.

198 *See* AICPA Letter; Eddy Letter; FPA Letter; IAA Letter; ICI Letter; Mercer Letter; Merrill Lynch Letter; Morgan Stanley Letter; MMI Letter; NAPFA Letter; NRS Letter; Pickard Letter; ProEquities Letter; Roundtable Letter; Schwab Letter; SIFMA Letter; Sutherland Letter; USAA Letter; comment letter of Wachovia Securities LLC (May 16, 2008) ("Wachovia Letter"); Wellington Letter, comment letter of Wall Street Financial Group (May 16, 2008) ("WSFG Letter").

199 *See, e.g.*, ASG Letter; comment letter of Clifford Swan Investment Counsel (May 5, 2008) ("Clifford Letter"); First Allied Letter; FPA Letter; FSI Letter; comment letter of Moody Aldrich Partners (May 15, 2008) ("Moody Aldrich Letter"); NRS Letter; Roundtable Letter; WSFG Letter.

200 *See* ASG Letter; Clifford Letter; Federated Letter; First Allied Letter; FPA Letter; FSI Letter; comment letter of the Investment Adviser Association (Aug. 26, 2008); Merrill Lynch Letter; Moody Aldrich Letter; NRS Letter; Roundtable Letter; Schnase Letter; WSFG Letter.

201 One commenter representing consumers agreed that such an approach could minimize the costs of delivery without significantly sacrificing investor protection. *See* Consumer Federation Letter.

202 *See* Electronic Media Release, *see supra* note196.

clients, regardless of whether the clients have provided consent to electronic delivery.[203] We note that an adviser's fiduciary duties may require it to obtain client consent to many of the disclosures required by Part 2 and that electronic access, without evidence that the adviser's delivery obligation has been met (such as by obtaining the client's consent to electronic delivery along with appropriate notice and access) would not, in our judgment, serve to adequately protect client interests.[204]

Some commenters recommended that advisers be required to send clients a notice providing a website link to where the brochure is posted on the Internet, rather than having to deliver the actual brochure to clients initially.[205] Another commenter objected, arguing that many investors are not yet willing to use the Internet to receive disclosure documents and that an approach that would rely on electronic delivery would be premature for retail investors.[206] We are not making such changes at this time, but will continue to consider different approaches to delivering financial information to investors.

Interim Delivery. As proposed, rule 204-3 requires advisers to deliver an updated brochure (or a document describing the material facts relating to the amended disciplinary event) promptly whenever the adviser amends its brochure to add a disciplinary event or to change material information already disclosed in response to Item 9 of Part 2A.[207] One commenter opposed the interim updating requirement, expressing concern that it would result in "frequent

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[203] *See, e.g.*, ABA Committees Letter; IAA Letter; Mercer Letter; Roundtable Letter; Sutherland Letter; Wachovia Letter.

[204] *See* Electronic Media Release, *supra* note 196 at Section II.A.3.

[205] *See, e.g.*, ASG Letter; Borek Letter; FSI Letter; ICI Letter; Lininger Letter; Merrill Lynch Letter; MMI Letter; Morgan Stanley Letter; NAPFA Letter; Pickard Letter; SIFMA Letter; Wellington Letter.

[206] *See* Consumer Federation Letter.

[207] *See* rule 204-3(b)(4).

interim disclosure of information of minimal relevance to clients."[208] We disagree. We believe that disclosure of disciplinary information is highly relevant to clients because it reflects on the integrity of the investment adviser, may affect a client's trust and confidence in the adviser, and may be of even greater interest if the adviser is adding disciplinary information frequently. Therefore, we are adopting this requirement as proposed.

b. Updating Part 2A of Form ADV

Similar to the existing requirements, the amended rules require advisers to keep the brochures they file with us current by updating them at least annually, and updating them promptly when any information in the brochures (except the summary of material changes and the amount of assets under management, which only has to be updated annually) becomes materially inaccurate.[209] In the case of both annual and interim updates, advisers will make changes to their brochures using their own computer systems and then simply file the revised versions of their brochures through IARD.[210]

In some cases, an adviser filing its annual updating amendment may not have any material changes to make to its brochure. If the adviser has not filed any interim amendments to its brochure since the last annual amendment and the brochure continues to be accurate in all material respects, the adviser would not have to prepare or deliver a summary of material changes to clients. The adviser also would not have to prepare and file an updated firm brochure as part of its annual updating amendment. If there was an interim amendment or the brochure contained a material inaccuracy, however, the adviser would have to file a summary of material

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208 *See* FSI Letter.

209 If an adviser is amending its brochure for a separate reason between annual amendments, and the amount of assets under management is materially inaccurate, the adviser should amend this disclosure. *See* Instruction 4 for Part 2A of Form ADV.

210 *See* rule 204-1(b).

changes describing any interim amendment(s) along with an updated firm brochure as part of its annual amendment filing. Although previously filed versions of an adviser's brochures will remain in the IARD system, only the most recent version of an adviser's brochure will be available to the public through the Commission's website.[211] The purpose of the public disclosure website is to provide the public with current information about advisers, rather than historic information.[212]

B. Part 2B: The Brochure Supplement

Rule 204-3 also requires that each firm brochure be accompanied by brochure supplements providing information about the advisory personnel on whom the particular client receiving the brochure relies for investment advice.[213] Among other things, the brochure supplements will contain information about the educational background, business experience, and disciplinary history (if any) of the supervised persons who provide advisory services to the client. The brochure supplement thus includes information that would not necessarily be included in the firm brochure about supervised persons of the adviser who actually provide the investment advice and interact with the client.

Several commenters supported the brochure supplement requirement.[214] One stated that the brochure supplement's "greater personal relevance to investors will make [it] among the

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211 In the case of an adviser that prepares, files and delivers to clients separate brochures for the various different advisory services it offers, the most recent version of *each* of its brochures will be available via the public disclosure website.

212 Instructions for obtaining historic brochure filings may be found at http://www.sec.gov/answers/publicdocs.htm.

213 *See* rule 204-3(b)(3). We believe that brochure supplements will be important to advisory clients in selecting an adviser because clients place great weight on the supervised person's qualifications and events that may reflect on the integrity of advisory personnel. *See* Proposing Release, *supra* note 8, at Section II.B.1.

214 *See* ASG Letter; Consumer Federation Letter; CFA Institute Letter; FPA Letter; IAA Letter; Lininger Letter; NASAA Letter.

most widely read of the disclosure documents they receive, particularly if they receive it in a timely fashion."[215] Another stated that the brochure items addressed areas of interest to clients and stated that "information on the qualifications and background of those who influence clients in connection with their investments are as relevant, if not more relevant, than the information currently required by Part 2 on senior executives of the firm that may have little or no direct contact with the client."[216]

Several advisers that also are registered as broker-dealers, however, urged that we not require a brochure supplement, arguing that the brochure supplement would prove excessively costly, that at least some of the information is available on the Financial Industry Regulatory Authority's (FINRA) web-based BrokerCheck system,[217] and that information not available through BrokerCheck (such as the "Educational Background," "Other Business Activities," "Additional Compensation," and "Supervision" sections) is either not important to clients or could be covered by general disclosure in the firm brochure about the firm's policies and procedures.[218] We disagree. We believe that the additional information required by the supplement will be important to many clients and, particularly for large advisers, cannot be sufficiently described by firm policies and procedures. For large advisers, such policies will by necessity tend to be general because they must cover a large number of supervised persons with a

215 Consumer Federation Letter.

216 CFA Institute Letter.

217 Another commenter argued against reliance on BrokerCheck. *See* Consumer Federation Letter.

218 *See, e.g.*, CGMI Letter; Merrill Lynch Letter; Morgan Stanley Letter; Schwab Letter; SIFMA Letter. BrokerCheck, which is designed to help investors check the professional background of current and former FINRA-registered securities firms and brokers, is available at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm. The following commenters argued that we should not require the brochure supplement because it would provide little new or useful information but would create significant costs and burdens. *See, e.g.*, NAPFA Letter; Pickard Letter; Roundtable Letter; USAA Letter; comment letter of John H. Vineyard (Mar. 18, 2008) ("Vineyard Letter"). For the reasons discussed in the text, we disagree.

range of ancillary activities and conflicts. For example, we do not believe that a prospective client would find it particularly helpful to read in the firm brochure that all of the adviser's associated persons had earned a college degree. Or that some of their associated persons had additional business activities that may involve conflicts of interest. Disclosure of such generalized information about the firm's associated persons is unlikely to be meaningful to clients seeking to understand the background, particular conflicts and outside business activities of the individual providing investment advice to them.

Commenters have, however, persuaded us to permit advisers to make use of BrokerCheck as well as the IAPD system to disclose disciplinary information available on those systems when the client has received a brochure supplement electronically.[219] The instructions for Part 2B of Form ADV provide that the adviser may disclose in a supplement delivered electronically that the supervised person has a disciplinary event and provide a hyperlink to either the BrokerCheck or the IAPD systems.[220] We believe that this accommodation addresses commenters' concerns regarding duplication of disclosure requirements, while meeting our objective of providing advisory clients with convenient access to information necessary to assess the individuals they are relying on for investment advice.[221] In addition to this accommodation, we have made several other changes to the proposed brochure supplement requirements in response to comments, which we discuss below.

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219 IAPD was recently enhanced to allow investors to obtain disciplinary history of supervised persons. *See* http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/12811.cfm for a press release announcing the launch of an enhancement to IAPD to allow users to search for individuals.

220 See Instruction 3 for Part 2B of Form ADV.

221 We also believe that this approach addresses the concern expressed by one commenter that reliance on BrokerCheck would hurt those investors who are least sophisticated and therefore are most likely to need this information, but who are the very ones that are least likely to seek it out. *See* Consumer Federation Letter.

1. Format

As proposed, the amendments require advisers to write their supplements in plain English, but offer an adviser flexibility in presenting information in a format that is best suited to the advisory firm. This flexibility is designed to reduce the cost of preparing and delivering supplements. Advisers may include supplement information within the firm's brochure, an approach that may be attractive to smaller firms with few persons for whom they will be required to prepare supplements.[222] Advisers may elect to prepare a supplement for each supervised person. Alternatively, they can prepare separate supplements for different groups of supervised persons (*e.g.*, all supervised persons in a particular office or work group). To promote comparability of brochure supplements, we are requiring that a brochure supplement must be organized in the same order, and contain the same headings, as the items appear in the form, whether provided in a brochure or separately.[223]

2. Supplement Items

Part 2B, as we proposed and as we are adopting it today, consists of six items. Many commenters who addressed the specific proposed items supported the content of the brochure supplements generally.[224] Others offered specific comments on certain items; we address these comments below.

Item 1. Cover Page. Each supplement's cover page must include information identifying the supervised person (or persons) covered by the supplement as well as the advisory firm. One

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222 IARD data as of May 3, 2010 indicate that 81% of advisers registered with us have 10 or fewer employees performing investment advisory functions on their behalf. Over 65% have five or fewer employees performing advisory functions.

223 If provided in a brochure, supplements must be included at the end of the brochure and be sequenced for each supervised person. *See* Instruction 1 of General Instructions for Part 2 of Form ADV and Instruction 6 for Part 2B of Form ADV.

224 *See, e.g.*, CFA Institute Letter, CFP Board Letter; FPA Letter.

commenter stated that the brochure supplement should not require a separate cover page.[225] We intended Item 1 of the brochure supplement to require that the information specified in the item be included on the front page of the supplement, not that this be the *only* information on a cover page. We have modified Item 1 accordingly to clarify that the information required by the item may be presented either on a separate cover page or at the top of the first page of the brochure supplement.

Item 2. Educational Background and Business Experience. Item 2 requires the supplement to describe the supervised person's formal education and his or her business background for the past five years.[226] If the supervised person either has no high school education, no formal education after high school, or no business background, the adviser must disclose this fact in the supplement. The business background section must identify the supervised person's positions at prior employers and not merely list the names of prior employers.[227]

Advisers may include information about professional designations in the supplement if they so choose. One commenter urged the Commission to require the listing of any professional designations held as long as the designations conform to the North American Securities Administrators Association (NASAA) model rules and state regulations that prohibit the misleading use of designations or certifications.[228] A few other commenters encouraged the Commission to require disclosure about the minimum qualifications required for any disclosed

225 *See* ASG Letter.

226 Previously, Item 6 of Part 2 of Form ADV required this information about the adviser's principal executive officers and about individuals who determine general investment advice on behalf of the adviser.

227 For example, clients may be interested in knowing that a supervised person was previously employed as an analyst at a hedge fund as opposed to being employed as a computer support specialist at a hedge fund.

228 *See* CFP Board Letter.

professional designation.[229] We are not electing to require a listing of professional designations as we do not require, nor do we endorse, any designations. We are concerned that the Commission requiring such disclosure could cause clients to mistakenly believe that we do endorse designations. We do believe, however, that some clients may be interested in learning of professional designations held by the individuals providing them with investment advice. However, we do not believe that such disclosure is meaningful without an explanation of the minimum qualifications required to obtain the designation. Accordingly, we are adding a requirement that if professional designations are disclosed in the supplement, the supplement must also provide a sufficient explanation of the minimum qualifications required for the designation to allow clients and potential clients to understand the value of the designation. The disclosure, of course, also cannot be materially false or misleading by suggesting, for example, that the designation implies more qualifications or experience than the actual designation standards require.[230]

<u>Item 3. Disciplinary Information</u>. Item 3 requires disclosure of any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity. It includes

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229 *See* ASG Letter; First Allied Letter; NASAA Letter. *But see* Vineyard Letter (stating that the supplement should not allow descriptions of professional designations since such disclosure could imply that the Commission advocated obtaining the particular designation).

230 We note that our staff and other securities regulators have warned that investors may be confused by some professional designations, such as those that imply expertise in providing services to seniors. *See Protecting Senior Investors: Report of Securities Firms Providing "Free Lunch" Sales Seminars*, Joint Report by the Staff of the Commission's Office of Compliance Inspections and Examinations, NASAA, and FINRA (*available at* http://www.sec.gov/spotlight/seniors/freelunchreport.pdf); Staff Update, *"Senior" Specialists and Advisors: What You Should Know About Professional Designations* (*available at* http://www.sec.gov/investor/pubs/senior-profdes.htm). While we acknowledge that a number of well-regarded professional designations and attainments exist, the required credentials, training, and experience associated with different designations vary widely. FINRA has established and maintains a database of designations used across the financial services industry that contains basic information about the designation, such as the issuing organization, prerequisites, and educational requirements. http://apps.finra.org/DataDirectory/1/prodesignations.aspx.

certain disciplinary events that the Commission presumes are material to such an evaluation if they occurred during the last 10 years.[231] Several commenters supported this requirement, and stated that such information would be of great interest to clients.[232]

As proposed, Item 3 of the supplement would have required disclosure of any event for which the supervised person had ever resigned or otherwise relinquished a professional attainment, designation or license in anticipation of it being suspended or revoked (other than for suspensions or revocations for failure to pay membership dues). Two commenters recommended that we not require this particular disclosure, stating that an adviser would not know a supervised person's reason for relinquishing a designation or license.[233] We recognize that an adviser may not always know why a supervised person is relinquishing a designation or license. We are modifying this requirement to clarify that this disclosure need only be made if the adviser knew or should have known that the supervised person relinquished his or her designation or license.

As discussed above, we are modifying Item 3 to permit advisers that send supplements electronically to clients to include hyperlinks to disciplinary information available through the FINRA BrokerCheck system as well as the IAPD system. A number of supervised persons of

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231 This list parallels the list of legal and disciplinary events in Item 9 of Part 2A that must be disclosed in the firm brochure and which are derived from the prior disclosure requirements set out in rule 206(4)-4. The list also is substantially similar to the list of disciplinary events advisers and their advisory affiliates are already required to disclose in response to Item 11 of Form ADV, Part 1A.

As under Item 9 of Part 2A, Item 3 of Part 2B permits an adviser to rebut the presumption with respect to a particular event, in which case no disclosure to clients about the event will be required. We require an adviser rebutting a presumption of materiality to document that determination in a memorandum and retain that record in order to better permit our staff to monitor compliance with this important disclosure requirement. As under Item 9 of Part 2A, a note in Item 3 explains four factors the adviser should consider when assessing whether the presumption can be rebutted.

232 *See* CFA Institute Letter; CFP Board Letter; Consumer Federation Letter; FPA Letter; NASAA Letter.

233 *See* First Allied Letter; IAA Letter.

investment advisers also are registered representatives of a broker-dealer firm or are subject to state investment adviser reporting requirements and thus may have disciplinary disclosure available through BrokerCheck or IAPD. Permitting advisers to hyperlink to these systems may minimize the costs of brochure supplements by leveraging existing infrastructure established by broker-dealer and adviser regulation. To take advantage of this provision, the brochure supplement must be delivered electronically and must include: (i) a statement that the supervised person has a disciplinary history, the details of which can be found on BrokerCheck or the IAPD (as the case may be); and (ii) a hyperlink to the relevant system with a brief explanation of how the client can access the disciplinary history.

Two commenters recommended that the Commission reconcile the disclosure requirements in Item 3 of the brochure supplement with Item 14 of Form U4, the uniform form used by broker-dealer and state investment advisory representatives to register (which includes certain disciplinary disclosure and is the source of such information that is available on BrokerCheck), stating that a lack of uniformity would complicate compliance.[234] We may consider in the future whether the disclosure requirements in Item 3 and in Form U4 should be conformed, as we recognize the substantial overlap between these disclosure items. We note, however, that although the disclosure requirements are not phrased identically, any disclosure required by the brochure supplement would also have to be disclosed on Form U4.

<u>Item 4. Other Business Activities</u>. Item 4 requires an adviser to describe other business activities of its supervised persons. The item specifically requires disclosure with respect to other capacities in which the supervised person participates in any investment-related business

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234 *See* ICI Letter; NASAA Letter.

and any material conflicts of interest such participation may create.[235] In addition, the item requires the supplement to include information about any compensation, including bonuses and non-cash compensation, the supervised person receives based on the sales of securities or other investment products, as well as an explanation of the incentives this type of compensation creates.[236] We are adopting this item substantially as proposed. We believe that disclosure of any such compensation is important because it creates an incentive for the supervised person to base investment recommendations on his or her own compensation rather than on clients' best interests.

We also are adopting a requirement to disclose *other* business activities or occupations that the supervised person engages in if they involve a substantial amount of time or pay.[237] Clients may have different expectations of an individual whose sole business is providing investment advice than of an individual who is engaged in other substantial business activities. Several commenters supported inclusion of this item.[238] A few commenters urged that we not require disclosure of this information,[239] with one commenter arguing that such information is irrelevant to the adviser's competence in providing investment advice,[240] and another stating that such a requirement would be burdensome.[241] We are retaining this requirement because we

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235 *See* Item 4.A of Part 2B.

236 *See* Item 4.A.2 of Part 2B.

237 *See* Item 4.B of Part 2B.

238 *See, e.g.*, Berlin Letter; CFA Institute Letter; CFP Board Letter; NASAA Letter. The NASAA Letter urged disclosure of all outside business activities regardless of whether they occupied a substantial amount of that person's time or income.

239 *See* IAA Letter; ProEquities Letter; Vineyard Letter.

240 *See* IAA Letter.

241 *See* ProEquities Letter.

believe that investors will find this information helpful in assessing the conflicts created by those activities.

Finally, some commenters stated that the Commission should define "substantial sources of income" and "substantial amount of time" by reference to specific percentages or in some other manner.[242] We believe that what amounts to "substantial" in many cases depends on particular facts and circumstances, and thus we are not establishing any specific definition of what is and is not substantial. However, we do understand the concern that there is likely some level at which a source of income or amount of time would rarely interfere or conflict with an adviser's business of providing investment advice. Accordingly, we are allowing advisers to make a presumption that if the other business activities represent less than 10 percent of the supervised person's time and income, they are not substantial.[243]

Item 5. Additional Compensation. This item requires that the supplement describe arrangements in which someone other than a client gives the supervised person an economic benefit (such as a sales award or other prize) for providing advisory services.[244]

Two commenters suggested that we not require this disclosure, with one of these commenters stating that disclosure of any conflicts arising out of such compensation arrangements is already required by an adviser's fiduciary duty and that firms should be free to make such disclosure in the firm's brochure or investment advisory contract, rather than in the brochure supplement.[245] We are adopting Item 5 as proposed. We believe clients need to know

242 *See* Case Letter; FSI Letter; ProEquities Letter; TAG Letter.

243 *See* Item 4.B of Part 2B.

244 Bonuses based (in part or whole) on sales, client referrals or new accounts trigger required disclosure, but other bonuses do not. Regular salaries need not be disclosed.

245 *See* Morgan Stanley Letter; Schwab Letter. Morgan Stanley made the comment regarding fiduciary duties.

if their individual adviser has these arrangements in order to assess the advisory services of that particular supervised person and that general disclosure of this conflict in a firm-wide brochure or advisory contract is not an adequate substitute. As we stated above, general disclosure of this type of conflict in many firm-wide brochures or advisory contracts will by necessity tend to be general because it must cover a variety of supervised persons with a range of compensation arrangements. Such general disclosure is unlikely to be meaningful to clients seeking to understand the particular compensation arrangements and associated conflicts of the individual providing investment advice to them.

Item 6. Supervision. This item requires an adviser to explain how the firm monitors the advice provided by the supervised person addressed in the brochure supplement. It also requires a firm to provide the client with the name, title, and telephone number of the person responsible for supervising the advisory activities of the supervised person.

We are adopting Item 6 as proposed. One commenter supported this requirement, stating that it is important for clients to have the ability to locate a person within a firm to whom they can direct questions or voice concerns about their accounts.[246] Some commenters recommended that the Commission not require this item, asserting that investors would not be interested in this information and that this requirement would not make sense for smaller advisory firms.[247] We believe that it is important for clients to be able to contact an appropriate person at an advisory firm, regardless of the firm's size, if they have any questions or complaints about the handling of their account. This will allow clients to determine appropriate redress for their complaints without having to go through the particular supervised person that is the focus of the complaint. Therefore, we are requiring this disclosure.

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246 *See* CFA Institute Letter.

247 *See* FPA Letter; FSI Letter; IAA Letter; Sutherland Letter.

Several commenters requested that the Commission permit advisers to furnish clients with a general contact number and email address instead of the name and contact information for the supervisor because supervisory personnel may change frequently, triggering the need for updated supplements, and because some supervised persons have multiple supervisors.[248] We do not agree with commenters' suggestion and are adopting this requirement as proposed. We believe that providing the name and telephone number of a specific individual responsible for supervising the representative's advisory activities will ensure that the client has ready access to the supervisor if the client has any complaints or concerns. In the unlikely event that a supervised person has more than one direct supervisor of his or her *advisory* services, the adviser may identify any one of those supervisors as long as that supervisor has the authority to respond to the client's question or complaint (or can raise the issue to a higher-level supervisor, if appropriate).

3. Delivery and Updating

a. Delivery

We are requiring as proposed that a client be given a brochure supplement for each supervised person who: (i) formulates investment advice for that client and has direct client contact; or (ii) makes discretionary investment decisions for that client's assets, even if the supervised person has no direct client contact. We believe that clients are most interested in learning about the background and experience of these individuals from whom they receive investment advice.

In the Proposing Release, we stated that an adviser would not, however, have to provide a supplement for a supervised person who provides discretionary advice only as part of a team and

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248 *See* FPA Letter; FSI Letter; Roundtable Letter; USAA Letter; Wachovia Letter.

has no direct client contact.[249] We explained our view that, when investment advice is formulated by a team, specific information about each individual team member takes on less importance. A few commenters stated that all representatives providing advice as part of a team will likely have direct client contact from time to time, and thus that the Commission's proposed exemption from the brochure supplement delivery requirement for supervised persons that provide advice as part of a team *and* that have no direct client contact, in fact, would not exempt any team members from this requirement as a practical matter, despite the limited utility of disclosure about each supervised person comprising a large advisory team.[250] We agree with commenters that volumes of disclosure about a large group of supervised persons likely would not be meaningful to investors. Accordingly, we are modifying this requirement, as suggested by one commenter,[251] based on the approach to disclosure under the Company Act where a team of individuals is jointly and primarily responsible for the day-to-day management of a mutual fund's portfolio.[252] If investment advice is provided by a team comprised of more than five supervised persons, brochure supplements need only be provided for the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client.[253]

Another commenter urged the Commission to exempt from the brochure supplement requirement any supervised persons providing non-discretionary advice (even if not part of a team).[254] A commenter representing investors strongly opposed this recommendation, arguing

249 *See* Proposing Release, *supra* note 8, at n.164.

250 *See, e.g.*, Federated Letter; ICI Letter; NAPFA Letter.

251 *See* ICI Letter.

252 *See* Instruction 2 for Item 5(b) of Form N-1A.

253 *See* rule 204-3(b)(3).

254 *See* SIFMA Letter.

that investors do not differentiate the advice they receive on this basis.[255] We believe that, where a supervised person is providing investment advice directly to a client, disclosure relating to the background and integrity of that person would be important to a client. It assists the client in evaluating the value of that investment advice, an evaluation we believe clients make regardless of whether the advice is non-discretionary.[256]

An adviser generally must provide its clients with a brochure supplement for each supervised person who provides the advisory services as described above. However, advisers are not required to deliver supplements to three types of clients: (i) clients to whom an adviser is not required to deliver a firm brochure (*e.g.*, registered investment companies and business development companies); (ii) clients who receive only impersonal investment advice;[257] and (iii) certain "qualified clients" who also are officers, directors, employees and other persons related to the adviser.[258] An adviser that does not have any clients to whom a supplement will have to be delivered will not have to prepare any supplements.[259] Similarly, an adviser will not have to

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255 *See* Consumer Federation Letter.

256 We note that an adviser's fiduciary duties to its clients under the Advisers Act do not turn on whether its advice is provided on a discretionary or non-discretionary basis.

257 This exception from the supplement delivery requirement differs slightly from the exception from the brochure delivery requirement, in that it does not depend on the cost of the impersonal advisory services involved. This is because in situations involving impersonal advisory services, the nature of the services are such that supervised persons of the adviser are unlikely to be directly providing advisory services to clients. As a result, we believe that in such situations requiring supplement delivery will result in an unnecessary expense with little appreciable benefit. We believe, however, that delivery of a firm brochure will be useful where the cost of the impersonal advisory services is significant, that is $500 or above.

258 Rule 205-3(d)(1)(iii) also defines certain related persons of an adviser as "qualified clients," including: (i) any executive officers, directors, trustees, general partners, or persons serving in a similar capacity, of the advisory firm; or (ii) any employees of the advisory firm (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of the firm and have been performing such functions or duties for at least 12 months.

259 *See* note to rule 203-1(a) and (b); Instruction 1 for Part 2B of Form ADV.

prepare a supplement for any supervised person who does not have clients to whom the adviser must deliver a supplement.

We proposed exempting advisers from delivering the brochure supplement to certain sophisticated clients,[260] and received several comments from those representing advisers supporting the exemption or urging its expansion.[261] The brochure supplement is intended to contain fundamental information about the qualifications of persons providing investment advice. Sophisticated clients are likely to request this type of information, even if not affirmatively provided by an investment adviser. Given that advisers will be preparing and delivering brochure supplements anyway, we believe the incremental burden of meeting the rule's obligations with respect to these sophisticated clients will be minimal and would not justify an exemption. We are therefore requiring that advisers deliver brochure supplements to all clients other than, as described above: (i) those clients to whom the adviser is not required to deliver a firm brochure; (ii) clients who receive only impersonal investment advice; and (iii) certain "qualified clients" who also are officers, directors, employees and other persons related to the adviser.

The supervised person's supplement initially must be given to each client at or before the time when *that* specific supervised person begins to provide advisory services to *that* specific client.[262] A few commenters argued that a large adviser with thousands of supervised persons may have staff changes on any given day and suggested that delivery be permitted *promptly after* the time the supervised person begins providing advisory services to the client.[263] But the

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260 *See* Proposing Release at Section II.B.1.

261 *See, e.g.*, IAA Letter; ICI Letter; Pickard Letter; T. Rowe Letter.

262 *See* rule 204-3(b)(3) and Instruction 3 for Part 2B of Form ADV.

263 *See* IAA Letter; ICI Letter.

brochure supplement is intended to assist investors in determining whether to retain the services of a particular adviser and in evaluating the individual advice they are receiving. This function could not be fully served if a client did not receive the supplement until after the supervised person already had begun providing advice to the client. As a result, we are adopting this delivery requirement as proposed.

b. Updating

We are adopting as proposed, the requirement that advisers deliver an updated supplement to clients only when there is new disclosure of a disciplinary event, or a material change to disciplinary information already disclosed, in response to Item 3 of Part 2B.[264] Because the final rule allows advisers to reference BrokerCheck or IAPD for disclosure of a supervised person's disciplinary information when the supplement is delivered electronically, if the supplement refers to BrokerCheck or IAPD a change in disclosure required by Part 2B would require the adviser to electronically deliver an updated supplement (or sticker) to clients when BrokerCheck or IAPD has been updated with new disclosure of a disciplinary event, or a material change to disciplinary information already disclosed, with the updated supplement (or sticker) indicating that the disciplinary information for the supervised person has changed and providing a hyperlink to BrokerCheck or IAPD. We believe this information is critical for clients because it reflects upon the supervised person's integrity and may affect a client's trust and confidence in that person and the adviser that employs the supervised person.

As with the brochure, advisers must amend a brochure supplement promptly if information in it becomes materially inaccurate.[265] Any new clients to whom the adviser is

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264 *See* rule 204-3(b)(4). We note that an adviser's fiduciary duty may require it to inform a client of material changes to disclosures in the supplement even if rule 204-3 does not require delivery of an updated supplement to clients.

265 *See* Instruction 4 for Part 2B of Form ADV.

obligated to deliver a supplement under our amended rule must be given an amended supplement (or the "old" supplement and a sticker). Supplements, like brochures, may be delivered on paper or electronically.[266] Because we believe most information in the supplement is unlikely to become materially inaccurate over time, advisers are not required to deliver supplements to existing clients annually. These requirements have not been modified from the proposal.

C. Filing Requirements, Public Availability

The Commission is amending rule 204-1 to require advisers to file their new brochures with us electronically through the IARD system.[267] Advisers are not required to file brochure supplements or supplement amendments with the Commission, and they will not be available on the Commission's public website.[268] Advisers are required to maintain copies of all supplements and amendments in their files.[269]

The IARD will accept brochure filings using the text-searchable Adobe Portable Document Format ("PDF").[270] The IARD provides advisers with online access to the Part 2A Items and instructions. Instead of completing Part 2A online, advisers will create their brochure on their own computers, convert it to a PDF, and then attach the completed document to their filing on IARD, much like attaching a document to an e-mail. To update brochures, advisers will

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266 *See* Instruction 5 for Part 2B of Form ADV.

267 Rule 204-1 had required advisers to file only "Part 1A of Form ADV" electronically. We are amending it to require Part 1A and Part 2A of Form ADV to be filed electronically.

268 *See* rules 203-1(a) and 204-1(b) and Instruction 9 for Part 2B of Form ADV. Because brochure supplements would not be filed with us, they would not be deemed filed and would not be required as part of any state notice filing. Section 307(a) of the National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (state securities authorities may only require SEC-registered advisers to file with the states copies of those documents advisers have filed with the Commission).

269 *See* rule 204-2(a)(14)(i) and Instruction 9 for Part 2B of Form ADV.

270 FINRA will assist investment advisers with converting brochures into a text-searchable PDF format using software available to the adviser or, if necessary, providing the adviser with PDF conversion software.

make the necessary changes to the source file on their own computers and then attach the revised versions to their IARD filing. The IARD will not accept an annual updating amendment without an updated brochure, a representation by that adviser that the brochure on file does not contain any materially inaccurate information, or a representation that the adviser does not have to prepare a brochure because it does not have to deliver it to any clients (*e.g.*, the adviser's clients are limited to registered investment companies). The IARD also will not accept an annual updating amendment without a representation that the summary of material changes is attached as an exhibit to or included in the updated brochure or a representation that no summary of material changes is required because there have been no material changes to the adviser's brochure since its last annual updating amendment.[271] If an adviser using multiple brochures discontinues using a particular brochure, the IARD system will permit the adviser to eliminate that brochure from its current filing.[272]

Most commenters addressing electronic filing supported the new filing requirement and public availability of the brochures.[273] Some, however, expressed concern that public disclosure of advisers' brochures through IAPD could reveal proprietary and confidential business information to competitors.[274] We have reviewed our requirements and do not believe that they would require disclosure of proprietary or confidential business information. Indeed, the

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271 If the adviser's summary of material changes is a separate document, the adviser must attach the summary as an exhibit to its brochure and upload the brochure and the summary in one single, text-searchable, PDF file on IARD.

272 Similarly, if an adviser is no longer required to prepare a brochure for delivery, the IARD system will permit the adviser to eliminate that brochure from its current filing.

273 *See* CGMI Letter; Fried Frank Letter; CFA Institute Letter; Katten Letter; NAPFA Letter; NASAA Letter; NRS Letter; NSCP Letter; Sidley Letter.

274 *See* comment letter of Brown & Brown Financial Services, Inc. (Mar. 27, 2008) ("Brown Letter"), comment letter of Executive Advisers, Inc. (May 14, 2008); comment letter of Larry Laws and Associates, Inc. (May 14, 2008); comment letter of James E. Wernli (May 20, 2008) ("Wernli Letter").

information that would be disclosed is very similar to that which we have long required to be disclosed by advisers in their brochures and which until 2000 was filed in paper with the Commission and publicly available.[275] We believe that there is a substantial public interest in having this information readily available to prospective clients, which may assist them in their search for an investment adviser. In addition, we believe that public disclosure will have a beneficial effect on business practices by, for example, discouraging advisers from engaging in certain practices because those practices would have to be publicly disclosed.

Other commenters expressed concern that a fund adviser's required public disclosure of Part 2 through IAPD could jeopardize the reliance of any private funds that it advised on the private offering exemption in the Securities Act of 1933 and the safe harbor for offshore transactions from the registration provisions in Section 5 of that statute.[276] We believe registrants can provide information required by Part 2 without jeopardizing reliance on those exemptions. The inclusion of private fund information beyond that required in Part 2, however, such as subscription instructions, performance information, and financial statements, may jeopardize such reliance by constituting a public offering or conditioning the market for the securities issued by those funds.

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[275] Until 2000, our rules required advisers to file both Part I and Part 2 of Form ADV with us and it was available in our public reference room. *See* Section I.C.2 of *Electronic Filing by Investment Advisers; Amendments to Form ADV*, Investment Advisers Act Release No. 1897 (Sept. 12, 2000) [65 FR 57438 (Sept. 22, 2000)].

[276] 15 U.S.C. 77e. Some expressed specific concern that the public disclosure may be deemed to violate the prohibition on "general solicitation" and "general advertising" that applies to private offerings conducted in accordance with Rule 506 of Regulation D. *See* AICA Letter; AIMA Letter; Fried Frank Letter; Janus Letter; NSCP Letter. One mentioned that the public disclosure could raise questions as to whether there are "directed selling efforts" in the United States, which would be inconsistent with the rules applicable to offshore offerings under Regulation S under the Securities Act. *See* Sidley Letter.

D. Transition to New Requirements

As discussed below in the discussion of compliance and effective dates,[277] we are adopting transition requirements that, as proposed, provide advisers with at least six months to comply with the amended rules and forms.[278] While a few commenters asked for more time to prepare the brochures and brochure supplements,[279] we believe the proposed transition period is sufficient. Advisers that are currently registered with us will have at least 8 months (from the end of July 2010 through the end of March 2011) to prepare and file narrative brochures as a result of the compliance dates discussed below. We also note that we have changed the period by which firms must deliver the new brochure and brochure supplements to their existing clients after this electronic filing compliance date from 30 days to 60 days to make sure that advisers have enough time to comply with the requirement.[280]

III. AMENDMENTS TO FORM ADV INSTRUCTIONS AND GLOSSARY

Together with the Part 2 amendments, we also are making conforming amendments to the General Instructions and the Glossary of Terms for Form ADV. We are amending the General Instructions to Form ADV to include instructions regarding brochure filing requirements. Similarly, we are amending the Glossary of Terms to add the following five terms that are used

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277 *See* Section V of this Release.

278 Rule 204-1(c). We proposed a transition schedule requiring advisers to comply with the new Part 2 requirements by the date they must make their next annual updating amendment to Form ADV following six months after the date the revised form becomes effective.

279 *See* AICPA Letter; First Allied Letter; NAPFA Letter; T. Rowe Letter.

280 Two commenters suggested a rolling transition over several months to avoid an inordinate demand on outside consulting and legal services by many advisers at the same time. *See* Fried Frank Letter; NAPFA Letter. We believe that the transition period we have provided to comply with the new Part 2 requirement permits advisers to work with their service providers in advance of the date their filings are required.

in Part 2: (i) "brochure;"[281] (ii) "brochure supplement;"[282] (iii) "custody;"[283] (iv) "investment adviser representative;"[284] (v) "supervised person;"[285] and (vi) "wrap brochure or wrap fee program brochure."[286] We also are updating the Glossary to reflect cross-references to these new terms, and cross-references to existing Glossary entries used in the revised portions of the Form.

We also are updating the Glossary to correct a discrepancy in the definition of "Non-Resident" to make it consistent with the definition in rule 0-2, the Advisers Act rule related to the procedures for serving process, pleadings, and other papers on non-resident investment advisers, and advisers' non-resident general partners and managing agents. This revision properly reflects

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281 "Brochure" means: "A written disclosure statement that you must provide to clients and prospective clients." *See* Form ADV: Glossary.

282 "Brochure supplement" means: "A written disclosure statement containing information about certain of your supervised persons that your firm is required by Part 2B of Form ADV to provide to clients and prospective clients." *See* Form ADV: Glossary.

283 "Custody" means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes: (i) Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them; (ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and (iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities." *See* rule 206(4)-2(d)(2).

284 "Investment adviser representative" means: "Any of your firm's supervised persons (except those that provide only impersonal investment advice) is an investment adviser representative, if – (i) the supervised person regularly solicits, meets with, or otherwise communicates with your firm's clients, (ii) the supervised person has more than five clients who are natural persons and not high net worth individuals, and (iii) more than ten percent of the supervised person's clients are natural persons and not high net worth individuals." *See* Form ADV: Glossary. *Cf.* rule 203A-3(a).

285 "Supervised person" means: "Any of your officers, partners, directors (or other persons occupying a similar status or performing similar functions), or employees, or any other person who provides investment advice on your behalf and is subject to your supervision or control." *See* Form ADV: Glossary.

286 "Wrap brochure or wrap fee program brochure" means: "The written disclosure statement that sponsors of wrap fee programs are required to provide to each of their wrap fee program clients." *See Form ADV: Glossary.*

the Commission's intent at the time the Glossary was originally adopted, that the definition of "Non-Resident" in the Glossary be the same as that in rule 0-2.[287] Although technical in nature, this amendment may potentially result in an increased number of corporate entities qualifying as non-resident general partners or managing agents of registered advisers. Certain entities will need to file Form ADV-NR with the Commission to appoint agents for service of process because they relied on the glossary definition and therefore were not required to file the form. We received no comments on these changes and are adopting them as proposed.

IV. AMENDMENTS TO RULE 204-2

We also are adopting conforming amendments to Advisers Act rule 204-2, the rule that sets forth the requirements for maintaining and preserving specified books and records, to require registered investment advisers to retain copies of each brochure, brochure supplement, and each amendment to the brochure and supplements that are prepared as required under the rule 204-3.[288] Additionally, the amendments require registered advisers to prepare and preserve documentation of the method they use to calculate managed assets for purposes of Item 4.E in Part 2A of Form ADV, if that method differs from the method used to calculate "assets under management" in Part 1A of Form ADV.[289] The amendments also require advisers to prepare and preserve a memorandum describing any legal or disciplinary event listed in Item 9 in Part 2A and Item 3 in Part 2B for the period the event is presumed material, if the event is not disclosed in the

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[287] This amendment will change the definition of "Non-Resident" to include "a corporation incorporated in *or* having its principal place of business in any place not subject to the jurisdiction of the United States." (emphasis added). *See* rule 0-2(b)(2) [17 CFR 275.0-2(b)(2)].

[288] *See* rule 204-2(a)(14)(i). The rule also will require advisers to keep and maintain a copy of the summary of material changes that is not included in the brochure, as well as a record of the dates that each brochure, amendment, and summary of material change was given to any client.

[289] *See* discussion at *supra* note 40 and accompanying text.

adviser's brochure or the relevant brochure supplement.[290] These records will be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a). We received no comments on these changes and are adopting them as proposed.

V. EFFECTIVE AND COMPLIANCE DATES

The amended rules and forms will be effective on [*insert date 60 days after publication*], 2010.

A. New Investment Advisers

Each adviser applying for registration with the Commission after January 1, 2011 must file a brochure or brochures that meet the requirements of amended Part 2A as part of the application for registration on Form ADV.[291] Such advisers must, upon registering, begin to deliver to their clients and prospective clients a brochure and brochure supplements that meet the requirements of the amended form in accordance with the amended rules discussed above.[292]

B. Registered Advisers

Each adviser registered with the Commission whose fiscal year ends on or after December 31, 2010, must include in its next annual updating amendment to its Form ADV a brochure or brochures that meet the requirements of the amended form.[293] Accordingly, each adviser with a fiscal year end of December 31, 2010 must file an annual updating amendment with the new brochures no later than March 31, 2011. Within 60 days of filing such amendment,

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290 *See* discussion at *supra* notes 86 - 89 and accompanying text.

291 Rule 203-1(b). This requirement applies only if the adviser is required to deliver a brochure. *See* note to Rule 203-1.

292 Rule 204-3(b).

293 Rule 204-1(c). This filing requirement applies only if the adviser is required to deliver a brochure. *See* note to Rule 203-1.

the adviser must deliver to its existing clients a brochure and brochure supplement that meet the requirements of amended Form ADV.[294] Each adviser must, after the initial filing of the brochures, begin to deliver to new clients and prospective clients a new brochure and brochure supplements in order to satisfy its obligations under the brochure rule.[295]

VI. PAPERWORK REDUCTION ACT

As explained in the Proposing Release, certain provisions of the rule and form amendments that we are adopting today contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[296] In the Proposing Release, the Commission published notice soliciting comment on the collection of information requirements. The Commission submitted the collection of information requirements to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, and OMB approved these collections of information under control numbers 3235-0049 (expiring 2/28/2011), 3235-0278 (expiring 3/31/2011), 3235-0047 (expiring 2/28/2011), and 3235-0345 (expiring 3/31/2011). The titles for these collections of information are "Form ADV," "Rule 204-2," "Rule 204-3," and "Rule 206(4)-4," respectively, all under the Advisers Act. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The respondents to the collections of information are investment advisers registered or applying for registration with us. We use the information to determine eligibility for registration with us and to manage our regulatory and examination programs. Clients use certain of the information to determine whether to hire or retain an adviser.

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294 Rule 204-3(g)(1).

295 Rule 204-3(g)(2).

296 44 U.S.C. 3501.

The rule and form amendments that we are adopting involve three distinct "collections of information" for purposes of the Paperwork Reduction Act. The first is the collection of information connected with Form ADV itself, specifically our amendments to Part 2 of Form ADV. The second collection of information involved is that under the amendment to rule 204-2, which requires advisers to maintain and preserve specified books and records. The third collection involved is that related to an amendment to rule 204-3, which requires advisers to deliver certain information required under Form ADV to their clients.

In addition, we are withdrawing rule 206(4)-4, the rule requiring advisers to disclose certain disciplinary and financial information, because the disclosure required by that rule is incorporated into the amendments to Part 2 of Form ADV that we are adopting.

A. Summary of Comment Letters

We requested comment on the Paperwork Reduction Act analysis contained in the Proposing Release. A number of commenters expressed concerns that the paperwork burdens associated with our proposed amendments to Part 2 of Form ADV were understated.[297] Several commenters stated that our estimates of the burdens of preparing and delivering brochure supplements were too low and that the requirement would impose heavy burdens on advisers, in particular, large advisory firms with thousands of employees and clients.[298] Several commenters noted that these costs would increase particularly in the context of wrap fee programs.[299] In response to comments on the requirements of Form ADV Part 2, we have made several substantive modifications to the proposed amendments that we believe in general will reduce the

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[297] *See* ASG Letter; Berlin Letter; Federated Letter; First Allied Letter; Fried Frank Letter; FSI Letter; IAA Letter; Jackson Letter; NAPFA Letter; NRS Letter; Pickard Letter; Sutherland Letter; Vineyard Letter.

[298] *See* Merrill Lynch Letter; Morgan Stanley Letter; Schwab Letter; SIFMA Letter; Sutherland Letter.

[299] *See* Federated Letter; MMI Letter; Morgan Stanley Letter.

paperwork burdens associated with the rule and form amendments. For example, we have modified the annual brochure delivery requirement to allow it to be satisfied by delivering just a summary of material changes in the brochure. We have revised Item 5 so that advisers do not need to include a fee schedule in brochures provided only to clients that are "qualified purchasers." We have not adopted proposed disclosure of cash balance practices and proxy voting services from Items 8 and 17, respectively. We are permitting supervised persons with certain disciplinary information disclosed through FINRA's BrokerCheck system or the IAPD system to refer clients to that information in their brochure supplements (if they are provided electronically and contain a hyperlink to the BrokerCheck or the IAPD system, as relevant) rather than reproducing that information. When investment advice is provided to a client by a team, we are requiring that brochure supplements need only be provided for the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client.

B. Revisions to Paperwork Reduction Act Burden Estimates

After considering commenters' concerns that the Commission's estimated paperwork burdens for firms complying with the amended Form ADV Part 2 were too low, and in light of revisions we have made to our proposed amendments to Part 2, we are revising our estimates for purposes of the Paperwork Reduction Act.

1. Amendments to Form ADV

a. Part 2 of Form ADV

The information required by the amendments to Form ADV is mandatory. Advisers are required to disclose this information to their clients and, therefore, it is not kept confidential. The currently approved total annual burden for all advisers completing, amending, and filing revised Form ADV with us is 132,599 hours. As stated in the Proposing Release, we continue to believe that most of the paperwork burden will be incurred in advisers' initial preparation of a

revised brochure and brochure supplements, as most advisers will have to draft a narrative brochure and all advisers will have to prepare new brochure supplements, and that over time this burden will decrease substantially because the paperwork burden will be limited to updating information. The paperwork burdens of preparing a narrative firm brochure and brochure supplements are likely to vary substantially among advisers, because Part 2 gives an adviser considerable flexibility in structuring its disclosure, the amount of disclosure required will vary among advisers, and the number of supplements that will need to be prepared depends on the number of supervised persons at a firm that provide investment advice. We believe that the revisions to Part 2 will impose a small burden on advisers in collecting information because there is a significant overlap between the information required by the previous Part 2 and the new Part 2A requirements and because advisers already collect information on the business background and disciplinary histories of their supervised persons to comply with state investment adviser representative registration requirements.[300] Accordingly, we expect that most of the paperwork burden from amended Part 2 will arise from an adviser drafting the narrative disclosure for its brochure and brochure supplements based on disclosures it and its supervised persons already made in Schedule F of Part 2 and in Form U4, and in expanding its discussion of how the adviser addresses certain conflicts of interest.

300 There are three entirely new items in the Part 2A we are adopting today—Item 2's summary of material changes, Item 6's performance fee disclosure requirement, and Item 15's custody disclosure requirement. The remainder of the items in Part 2A either were generally covered by the previous Part 2 or were required disclosure under other Advisers Act rules, such as rule 206(4)-6 regarding proxy voting and rule 206(4)-4 regarding financial and disciplinary information. In addition, most states require that supervised persons of SEC-registered investment advisers that are investment adviser representatives file Form U4, which requires similar business background and disciplinary information as the brochure supplement.

As noted above, we have revised our estimated burdens for purposes of the Paperwork Reduction Act to take into account comments received as well as substantive modifications to Part 2 from the form that was proposed.

In the Proposing Release, we estimated the average initial annual burden associated with Form ADV to be 5 hours for smaller advisers.[301] We received several comments that provided estimates of the paperwork burden associated with the proposed rule and form amendments for small advisers. One commenter estimated that preparing the initial Form ADV Part 2 would require 16 to 40 hours, depending on the nature of the firm's business, and that each subsequent amendment to that form would take 10 to 32 hours, depending on the nature of the amendments.[302] Another said that a small firm would take 60 hours to draft the initial brochure.[303] A small firm commenter estimated that it would take 40 to 60 hours to prepare the initial brochure and another 20 to 40 hours per year thereafter to update it.[304] A compliance consulting firm estimated that it would take on average 15 hours for a small firm to prepare the initial brochure.[305] One law firm estimated that smaller advisers would spend at least 44.5 hours preparing the new brochure.[306] We do not believe that small advisers will require as many as 60 hours for their initial revision of Part 2A because, as discussed above, firms already have collected much of the information for Part 2A, many of the disclosures were already required under previous Part 2 requirements or other Advisers Act rules or as a result of the adviser's

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301 For purposes of the estimates in this section, we have categorized small advisers as those with 10 or fewer employees, medium-sized advisers as those with between 11 and 1,000 employees, and large advisers as those with over 1,000 employees. Unless otherwise noted, the IARD data cited below is based on advisers' responses to questions on Part 1A of Form ADV as of May 3, 2010.

302 ASG Letter.

303 NAPFA Letter.

304 Jackson Letter.

305 NCS Letter.

306 Fried Frank Letter.

fiduciary obligations, and small advisers are unlikely to have extensive conflicts of interest that would necessitate lengthy brochure disclosures. We have reviewed several brochures of small investment advisers drafted in a narrative format that would appear to be generally responsive to the requirements we are adopting today, and these brochures are short, likely because of the relative simplicity of most small advisers' business models.[307] We also do not believe that small advisers will spend significant amounts of time preparing brochure supplements because they have a small number of supervised persons. Based on these considerations, we estimate that the average initial annual burden associated with Form ADV to be at the low end of the 15 to 60 hour range provided by commenters, or 15 hours for each small adviser.

In the Proposing Release, we estimated that the average initial annual burden associated with Form ADV for medium-sized advisers would be approximately 50 hours. We received a comment from a medium-sized adviser stating that it currently spends approximately 45 hours per year to update its Part 2 brochure.[308] This commenter did not estimate how long it took to prepare its initial Part 2 brochure under the prior format and did not estimate how long it would take to prepare or update the new Part 2A brochure and brochure supplements. We received a comment from another medium-sized adviser estimating that it would take a minimum of 163 hours for the initial preparation and internal handling of the brochure supplement.[309] Most of our medium-sized advisers are closer to the size of small advisers than large advisers, with 77% of medium-sized advisers having between 11 and 50 employees.[310] Accordingly, we expect that

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307 We note that advisers that choose to disclose more than is required by Part 2A (or their fiduciary obligations) will create lengthier brochures than those that take a more focused approach.

308 *See* Federated Letter.

309 *See* First Allied Letter. The First Allied Letter stated that it had approximately 325 investment advisory representatives and assumed that each supplement would take 30 minutes to prepare.

310 Based on IARD data as of May 3, 2010.

while these advisers will have a higher burden than smaller advisers due to the greater size and complexity of their business model, the majority will not have burdens dramatically greater than small advisers. We also estimated that each medium adviser, on average, will require 30 minutes to prepare each brochure supplement, based on an estimate of brochure supplement preparation time provided by one medium adviser commenter.[311] Based on these considerations and the comments on small firm burdens, we have revised our estimate of the average initial annual burden associated with Form ADV for each medium-sized adviser to be 97.5 hours.[312]

Finally, in the Proposing Release we estimated that the average initial annual burden associated with Form ADV for large advisers would be approximately 3,300 hours. We received no estimates from commenters of the burden on large advisers from preparing the new brochure. We received estimates from two of the largest advisers that the brochure supplement would require between 30,000 to 45,000 hours initially.[313] Unlike with respect to small and medium advisers, the brochure supplement dramatically increases the estimated burden associated with

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311 First Allied Letter.

312 We assume that preparing Part 1 and Part 2A of Form ADV would take each medium adviser on average 60 hours per year based on our estimate for smaller advisers, the fact that the average medium adviser is closer in size to a small adviser than a large adviser, the discussion above that advisers already have much of the information required by the new Part 2A and it is largely a matter of converting it to a narrative format, and the one comment we did receive from a medium sized adviser on the time it took to amend its brochure annually. We estimate that each medium adviser, on average, has 75 supervised persons based on the average number of employees performing investment advisory functions at medium sized advisers according to IARD data. We thus estimated that each medium adviser on average would spend 37.5 hours preparing the initial brochure supplements (75 supervised persons x 30 minutes per supervised person = 37.5 hours per year), for a total of 97.5 hours for the initial preparation of all of Form ADV.

313 The Merrill Lynch Letter estimated that the brochure supplement requirement would require 45,000 hours per year. The Morgan Stanley Letter estimated that it would take in the range of 30,000 to 35,000 hours for it to comply with the brochure supplement requirement initially and 8,000 to 10,000 hours annually to comply going forward. In their comment letters, Merrill Lynch and Morgan Stanley stated that approximately 8,000 and 14,000 employees, respectively, performed investment advisory functions at their firms. These employee numbers place these two commenters at the highest end of the range of the 36 advisers in our large category with only four other firms reporting as of May 3, 2010 that they had 8,000 or more employees performing such functions.

preparing Form ADV for large advisers because of their significantly larger number of employees that provide investment advice (some with over 1,000 per firm according to IARD data). The primary difference between the burden associated with preparing the brochure for large and smaller firms is the likelihood that there will be additional items to which large firms will have to respond and the likelihood that large firms will have additional conflicts of interest to address. We estimate that these additional brochure disclosures will add a relatively small amount compared to the burden estimate for medium advisers, but that the brochure supplement requirement will add a significant burden compared to medium advisers. We do not expect the burden for most large firms to be as substantial, on average, as estimated in the Merrill Lynch and Morgan Stanley comment letters, however, because these firms based their estimate on substantially more supervised persons providing investment advisory services than an average large adviser.[314] We estimate that preparing Part 1 and Part 2A of Form ADV would take each large adviser on average 100 hours per year.[315] Based on commenters' estimates, we now estimate that the brochure supplement will take each large adviser on average 30 minutes per supervised person to collect and prepare a supplement.[316] As a result, we now estimate the

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314 *See supra* note 114.

315 This estimate is based on our estimate for medium advisers, the discussion above that advisers already have much of the information required by the new Part 2A and it is largely a matter of converting it to a narrative format, and our view that the additional disclosure required by large advisers' business models is not so substantial as to require dramatically more brochure preparation time than medium advisers.

316 We estimate that each large adviser, on average, has 3,777 supervised persons based on the average number of employees performing investment advisory functions at large advisers according to IARD data. The Merrill Lynch Letter estimated that each supplement would require 3 hours to prepare. We believe that this estimate includes the burden to track and update brochure supplements which we discuss and account for separately, and which are not part of this burden estimate. We do not expect that brochure supplements for supervised persons at large advisers are likely to require more preparation time than supplements at medium advisers, particularly when more supervised persons at large advisers than medium advisers are likely to have information available through BrokerCheck or the IAPD that can be referenced in those supervised persons' supplements, reducing supplement preparation time. Brochure supplements

initial average burden associated with preparing Form ADV for each large adviser to be 1,989 hours.[317]

In the Proposing Release, we estimated that an average investment adviser's collection of information burden associated with initial preparation of Form ADV would be 22.25 hours per year. According to IARD data, there are 9,482 small advisers, 2,140 medium-sized advisers, and 36 large advisers. Based on the revised hourly burden estimates discussed above, we now believe that 36.24 hours is an accurate reflection of the time that it will take the *average* adviser to initially complete revised Form ADV (including both Parts 1 and 2).[318] This is an increase of 13.99 hours over our initial estimate.

Respondents under this collection of information will be advisers registered with the Commission as well as new applicants for investment adviser registration with the Commission. We estimate that approximately 1000 new investment advisers will register with us each year.[319] Thus, in combination with the approximately 11,658 existing investment advisers registered with the Commission, we estimate that the total number of respondents under this collection of information will be 12,658 advisers. Based on the estimated average collection of information burden of 36.24 hours per adviser, the total initial collection of information would amount to 458,726 hours for new registrants and for currently registered advisers that re-file Form ADV

consist of only 6 disclosure items, several of which (*i.e.*, cover page, supervision, education) are simple to collect and draft in a few minutes). Accordingly, we estimate that an adviser would spend 30 minutes per supervised person to collect and prepare a supplement.

317 We estimate that each large adviser on average would spend 1,889 hours preparing the initial brochure supplements (3,777 supervised persons x 30 minutes per supervised person = 1,889 hours per year), for a total of 1,989 hours per year on average per large adviser for the initial preparation of all of Form ADV.

318 9,482 small advisers x an estimated 15 hours/adviser + 2,140 medium-sized advisers x an estimated 97.5 hours/adviser + 36 large advisers x an estimated 1,989 hours/adviser = 422,484 hours total. 422,484 hours / 11,658 total advisers = 36.24 hours/adviser.

319 Based on IARD data over the last five years.

(including Part 2) through the IARD system.[320] Amortizing this total burden imposed by Form ADV over a three-year period to reflect the anticipated period of time that advisers would use the revised Form would result in an average burden of an estimated 152,909 hours per year,[321] or 12.08 hours per year for each new applicant and for each adviser currently registered with the Commission that would re-file through the IARD.[322]

We estimate that some advisers may incur a one-time initial cost for outside legal and compliance consulting fees in connection with preparation of Part 2 of Form ADV. While we received no specific comments on our estimate regarding outside legal costs in the Proposing Release, one commenter did state that compliance consultants assist a significant percentage of advisers in preparing their Form ADV.[323] As a result, we are changing our estimate to reflect a quarter of small advisers using compliance consulting services and a quarter of small advisers using outside legal services and to reflect half of medium advisers using compliance consulting services in lieu of outside legal services and a quarter of medium advisers still using outside legal services. We estimate that the initial per adviser cost for legal services related to preparation of Part 2 of Form ADV would be $3,200 for small advisers, $4,400 for medium-sized advisers, and $10,400 for larger advisers.[324] We estimate that the initial per adviser cost for compliance consulting services related to initial preparation of the amended Form ADV will range from

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320 (12,658 advisers x 36.24 hours) = 458,726 hours.

321 458,726 hours / 3 years = 152,909 hours/year.

322 152,909 hours / 12,658 advisers = 12.08 hours/adviser.

323 *See* NCS Letter.

324 Outside legal fees are in addition to the projected hourly per adviser burden discussed above. $400 per hour for legal services x 8 hours per small adviser = $3,200. $400 per hour for legal services x 11 hours per medium-sized adviser = $4,400. $400 per hour for legal services x 26 hours per large adviser = $10,400. The hourly cost estimate of $400 on average is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

$3,000 for smaller advisers to $5,000 for medium-sized advisers.[325] We estimate that a quarter of small and half of medium advisers, or 2,371 and 1,070 advisers, respectively, are likely to seek outside compliance consulting services in their preparation of Form ADV.[326] We estimate that a quarter of small advisers, or 2,370 advisers, and a quarter of medium advisers, or 535 advisers, are likely to engage outside legal services.[327] We estimate that all of the 36 large advisers will engage outside legal services in preparation of Form ADV. Thus, we estimate that approximately 2,941 advisers will elect to obtain outside legal assistance and approximately 3,441 advisers will elect to obtain outside consulting services, for a total cost among all respondents of $22,775,400.[328]

In addition to the burdens associated with initial completion and filing of the revised form, we estimate that, on average, each adviser filing Form ADV through the IARD system will likely amend its form two times during the year.[329] A few commenters believed that we had underestimated the information burden associated with amending Form ADV.[330] As a result, we

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325 Outside compliance consulting fees are in addition to the projected hourly per adviser burden discussed above. Based on consultation with compliance consulting firms who regularly assist investment advisers in Form ADV preparation, we estimate that small advisers will incur expenses of $3000 per year for the initial preparation of the new Form ADV and medium advisers will incur expenses of $5000 per year for the initial preparation of the new Form ADV.

326 9,482 small advisers x 0.25 = 2,371. 2,140 medium-sized advisers x 0.5 = 1,070.

327 2,140 medium-sized advisers x 0.25 = 535.

328 For outside legal services, ($4,400 x 535 medium advisers) + ($3,200 x 2,370 small advisers)) + ($10,400 x 36 large advisers) = $ 10,312,400. For compliance consulting services, ($3,000 x 2,371 small advisers) + ($5,000 x 1,070 medium advisers) = $12,463,000. $10,312,400+$12,463,000 = $22,775,400

329 In the Proposing Release, we estimated that each adviser, on average, filing Form ADV through the IARD system amended its form 1.5 times per year. We have updated this estimate based on IARD system data regarding the number of filings of Form ADV amendments.

330 In the Proposing Release, we estimated that each adviser, on average, would spend 0.75 hours per year amending its Form ADV. The ASG Letter estimated that amendments to Part 2 would take 10 to 32 hours, depending on the nature of the amendments. The Jackson Letter estimated that it would take small firms 20 to 40 hours per year to update Part 2. The Federated Letter stated that they currently spend approximately 45 hours per year amending the previous Part 2.

are revising our estimate of the collection of information burden for preparing amendments. One of the two amendments that firms on average make each year will be an interim updating amendment, and we estimate that this amendment will require 0.5 hours per amendment because interim amendments typically only amend one or two items[331] in Form ADV and thus should not require much time to prepare. The other amendment is the firm's annual updating amendment of Form ADV. Part 2A requires only a few additional requirements with the annual updating amendment than is required throughout the year—the summary of material changes since the last annual updating amendment, an updated fee schedule, and an updated figure for assets under management. We also expect that advisers will not have to spend a significant amount of time generally reviewing their brochure before filing their annual updating amendment as the instructions to the form and their fiduciary obligations require them to keep information they provide to clients free of material inaccuracies. Based on these considerations, we estimate that the average adviser will spend 6 hours per year completing their annual updating amendment to Form ADV. Finally, we believe that the information required in the brochure supplements is unlikely to change frequently for any particular supervised person, and, as a result, that brochure supplements will be amended infrequently.[332] We also estimate that changes to most of the supplement information is already tracked by advisers in order to allow them to keep Forms U4 for their investment advisory representatives current, and that tracking changes to this information for brochure supplement purposes as well will impose negligible additional costs. Accordingly, we estimate that it will require an average burden per adviser of one hour per year

331 Based on IARD system data.

332 Largely for this reason, we have not broken down our estimated burden for preparing the annual updating amendment to Form ADV based on the size of the adviser since most of the difference in the initial Form ADV preparation burden was driven by the brochure supplement. We also do not believe that the burden for preparing an annual updating amendment to Part 2A of Form ADV will vary significantly based on the size of the adviser.

for interim amendments to brochure supplements, for a total burden on all advisers of 11,658 hours per year.[333] Thus, we estimate that the total paperwork burden on advisers of amendments to Form ADV will be 87,435 hours per year.[334]

Commenters also highlighted the fact that the particular supervised persons for whom the adviser will have to deliver brochure supplements to particular clients will change over time and that these changes will generate costs.[335] The adviser may hire new employees who may begin providing investment advisory services that require preparation of a brochure supplement. We estimate that advisers on average will hire two new supervised persons each year for which a brochure supplement would have to be prepared.[336] We further estimate that, on average, an adviser will spend 0.5 hours preparing each new brochure supplement.[337] Preparation of these new supplements thus would require all advisers to spend 11,658 hours per year.[338]

The revised total annual collection of information burden for advisers to file and complete the revised Form ADV (Parts 1 and 2), including the initial burden for both existing and anticipated new registrants plus the burden associated with amendments to the form as well as creating new supplements for new employees, is estimated to be approximately 252,002 hours

333 1 hour per year x 11,658 advisers = 11,658 hours per year.

334 11,658 advisers x 1 interim brochure amendment per year x 0.5 hours = 5,829 hours per year for interim amendments. 11,658 advisers x 1 annual brochure amendment per year x 6 hours = 69,948 hours per year for annual amendments. 11,658 advisers x 1 hour per year for supplement amendments = 11,658 hours per year for supplement amendments. 5,829 + 69,948 + 11,658 = 87,435 hours.

335 *See, e.g.*, Schwab Letter; SIFMA Letter; Sutherland Letter.

336 Estimate is weighted average based on analysis of changes in aggregate responses to Item 5.B(1) of Part 1A of Form ADV over the last 5 years and the number of investment advisers registered with the Commission.

337 See discussion at *supra* note 311 and accompanying text.

338 Two new supervised persons per year x 0.5 hours per supplement x 11,658 investment advisers = 11,658.

per year.[339] This burden represents an increase of 151,026 hours over that estimated in the Proposing Release.[340] This increase is attributable primarily to our increased estimates of the hourly preparation burden associated with Part 2 in response to comments. As discussed in the Proposing Release, in addition to these estimated burdens, under this collection of information there is also a burden of 16,455 hours associated with advisers' obligations to deliver to clients copies of their adviser codes of ethics upon request.[341] Thus, the estimated revised total annual hourly burden under this collection of information would be 268,457 hours.[342] This represents an increase of 135,858 hours per year from the currently approved burden.[343]

b. Rule 206(4)-4

Rule 206(4)-4 currently requires advisers to disclose certain disciplinary and financial information to clients. We are rescinding rule 206(4)-4 and incorporating its substantive provisions into Part 2 of Form ADV. The collection of information burden associated with the requirements of rule 206(4)-4 has been incorporated into the collection of information requirements for Form ADV, discussed above. Thus, the currently approved burden estimate for

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339 152,909 hours per year attributable initial preparation of Form ADV + 87,435 hours per year for amendments to Form ADV + 11,658 hours per year for supplements for new employees = 252,002 hours.

340 Revised burden 252,002 hours - proposing release burden of 100,976 hours = 151,026 hours.

341 *See* Code of Ethics Adopting Release, *supra* note114. As we estimated in the Proposing Release (and on which we received no comment), we estimate that only one percent of an adviser's clients actually request a copy the adviser's code of ethics. 0.01 x 1,300 (the estimated average number of clients per adviser) = 13 requests per registrant. *See infra* note 357 regarding the estimated average number of clients. We continue to estimate that responding to each such request involves a burden of 0.10 hours, amounting to an annual burden of 1.3 hours for each adviser stemming from the obligation to deliver copies of their codes of ethics to clients. 13 requests per adviser x 0.10 hours = 1.3 hours/adviser. This obligation applies to both currently-registered (11,658 respondents) and newly-registered advisers (1000 respondents), for a total annual burden of 16,455 hours. 12,658 respondents x 1.3 hours = 16,455 hours.

342 16,455 hours + 252,002 hours = 268,457 hours.

343 Revised burden 268,457 hours - currently approved burden of 132,599 hours = 135,858 hours.

Form ADV already includes an estimate of the burdens associated with the disclosure of disciplinary and financial information connected with Part 2.

2. Rule 204-2

This requirement is found at 17 CFR 275.204-2 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program, and the information generally is kept confidential.[344] The likely respondents to this collection of information requirement are all of the approximately 11,658 advisers currently registered with the Commission.

The amendments to rule 204-2 require advisers to prepare and preserve a memorandum describing any legal or disciplinary event listed in Item 9 in Part 2A of Form ADV and Item 3 in Part 2B of Form ADV, if the event is not disclosed in the adviser's brochure or the relevant brochure supplement. Additionally, the amendments require advisers to prepare and preserve documentation of the method they use to calculate managed assets for purposes of Item 4.E. in Part 2A of Form ADV, if that method differs from the method used to calculate "assets under management" in Part 1A of Form ADV. These records are required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a).

As we stated in the Proposing Release, we believe that the amendments to rule 204-2 will result in an increased burden of four hours for each adviser subject to the additional requirements. We received no comments on the Commission's burden estimates relating to rule 204-2 and are leaving these estimates unchanged, except to update collection estimates based on IARD data.

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[344] *See* section 210(b) of the Advisers Act (15 U.S.C. 80b-10(b)).

We estimate that 350 advisers will use a method for calculating managed assets in Part 2A that differs from the method used to compute assets under management in Part 1A and thus would be required to prepare and preserve documentation describing the method used in Part 2A.[345] We also estimate that 156 advisers will conclude that the materiality presumption in Part 2 has been overcome with respect to a legal or disciplinary event, will determine not to disclose that event, and therefore would be required to prepare and preserve a memorandum describing the event.[346]

We estimate that a total of 506 advisers will have to prepare and preserve additional records in accordance with amendments to rule 204-2.[347] Only 487 of these are already accounted for in the currently approved burden estimate. We estimate that adding 19 advisers to those subject to the amended provisions of rule 204-2 will yield a 76 hour increase in burden under the rule.[348]

The approved annual aggregate burden for rule 204-2 is currently 1,954,109 hours based on an estimate of 10,787 registered advisers, or 181.15 per registered adviser.[349] Taking into account the estimated increased burden of 76 hours as discussed above, as well as an increase of

345 Based on the Commission staff's conversations with industry professionals, we anticipate that approximately three percent of the 11,658 advisers registered with us as of May 3, 2010 will use a method for computing managed assets in Part 2A of Form ADV that differs from the method used to compute assets under management in Part 1A of Form ADV. 11,658 advisers x 0.03 = 350 advisers.

346 Approximately 1,559 advisers registered with the Commission report disciplinary information in Part 1A of their Form ADV as of May 3, 2010. We anticipate that most of these advisers will include all disciplinary information in their brochures and supplements, but that approximately 10% of these advisers, or 156, will need to prepare and preserve a memorandum explaining their basis for not disclosing a legal or disciplinary event listed in Part 2 in their brochures and supplements. 1,559 advisers x 0.10 = 156 advisers.

347 350 advisers that we estimate would prepare memoranda regarding an alternative method for calculating assets under management + 156 advisers that we estimate would prepare memoranda regarding unreported nonmaterial disciplinary events = 506 advisers.

348 506 advisers – 487 advisers = 19 advisers. 19 advisers x 4.0 hours = 76 hours.

349 1,954,109 hours / 10,787 registered advisers = 181.15 hours per adviser.

871 registered advisers,[350] the revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 204-2 is therefore estimated to be 2,111,967 total hours.[351]

We further estimate that some advisers may incur a one-time cost for outside legal fees in connection with preparing a memorandum explaining their basis for not disclosing a legal event listed in Part 2 in their brochures and supplements. We estimate this one-time cost would include fees for approximately three hours of outside legal review and would amount on average to approximately $1,200 per adviser.[352] We believe that approximately 80 percent of the advisers preparing such memoranda would likely engage outside legal services to assist in their preparation.[353] Thus, we estimate that approximately 125 advisers will incur these costs, for a total cost among all respondents of $150,000.[354]

3. Rule 204-3

Rule 204-3 contains a collection of information requirement. This collection of information is found at 17 CFR 275.204-3 and is mandatory. Responses are not kept confidential. The likely respondents to this information collection are the approximately 11,658 investment advisers registered with the Commission.

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350 As stated above, our IARD data show that as of May 3, 2010 there were 11,658 advisers registered with the SEC. 11,658 – 10,787 = 871.

351 (1,954,109 current burden hours + 76 hours due to an increase in the estimated number of registered advisers subject to additional recordkeeping under the amendments + (871 due to an increase of total number of registered advisers x 181.15 hours per adviser)) = 2,111,967. The annual average burden per registered adviser is therefore 181.16 hours. 2,111,967 total hours / 11,658 advisers = 181.16 hours per adviser.

352 Outside legal fees are in addition to the projected hourly per adviser burden discussed above. $400 per hour for legal services x 3 hours per adviser = $1,200. The hourly cost estimate is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

353 We made the same estimate in the Proposing Release and received no comment on this estimate.

354 156 advisers x 0.80 = 125. $1,200 x 125 = $150,000.

Rule 204-3 previously required an investment adviser to deliver to clients, at the start of an advisory relationship, a copy of Part 2 of Form ADV or a written document containing at least the information required by Part 2. The rule previously required no further brochure delivery unless the client accepted the adviser's required annual offer. The brochure assists the client in determining whether to hire or retain an adviser.

The amendments to rule 204-3 require advisers to deliver their brochures and brochure supplements at the start of an advisory relationship and to deliver annually thereafter the full updated brochure or a summary of material changes to their brochure.[355] The amendments also require that advisers deliver an amended brochure or brochure supplement (or just a statement describing the amendment) to clients only when disciplinary information in the brochure or supplement becomes materially inaccurate.[356]

The total annual burden currently approved by OMB for rule 204-3 is 6,902,278 hours. This currently approved burden is based on each adviser having, on average, an estimated 670 clients. Our records now currently indicate that the 11,658 advisers registered with the Commission have, on average, 1,300 clients.[357] This change, along with our amendments permitting annual delivery of a summary of material changes to the brochure (instead of the entire brochure) alters the collection of information burden from that currently approved.

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355 *See* rule 204-3(b).

356 *See* rule 204-3(b).

357 This average is based on advisers' responses to Item 5.C of Part 1A of Form ADV as of May 3, 2010, excluding the three advisers that reported the largest number of clients. Those advisers account for over 50% of all advisory clients of SEC registrants and not excluding them would raise the average client count to 2,576 clients. These three firms provide advisory services primarily over the Internet and currently meet their brochure obligations electronically, thus essentially entirely eliminating for these advisers any PRA burden associated with delivery under this rule. Therefore, we believe that it is appropriate to exclude these firms from our calculations.

We expect that advisers will send their brochure or summary of material changes annually in a "bulk mailing" to clients that may include clients' account statements, periodic reports, or other important documents. We estimate that, with a bulk mailing, an adviser will require no more than 0.02 hours to send the adviser's brochure or summary of material changes to each client, or an annual burden of 26 hours per adviser.[358] Thus, we estimate the total burden hours for 11,658 advisers to distribute their firm brochure to existing clients initially and annually thereafter to be 303,108 hours per year.[359] We have revised our estimate of the amount of time it will take an adviser to deliver its brochure or summary of material changes based on our view that most advisers will make their annual delivery as part of the mailing of an account statement or other periodic report that they already make to clients, and thus the additional burden will be adding a few pages to the mailing.

Advisers also will be required to distribute interim updates disclosing new or revised disciplinary information in their brochure or supplements. We anticipate that in any given year, the number of such interim updates that advisers will be required to deliver is approximately 583.[360] We further estimate that an adviser will require no more than 0.1 hours per client for

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358 (0.02 hours per client x 1,300 clients per adviser based on IARD data as of May 3, 2010) = 26 hours per adviser. We note that the burden for *preparing* brochures is already incorporated into the burden estimate for Form ADV discussed above. The Proposing Release estimated that it would require 0.25 hours to send the adviser's brochure to each client. Upon further consideration we determined that it would not take an adviser 15 minutes to mail or email an adviser's brochure to a client.

359 (0.02 hours per client x 1,300 clients per adviser) x 11,658 advisers based on IARD data as of May 3, 2010 = 303,108 hours.

360 Of the advisers registered with the Commission, 13% report disciplinary events on their Form ADVs (as of May 10, 2010, only 1,559 of all 11,658 registered advisers indicated at least one "yes" answer to a question related to disciplinary events in Form ADV, Part 1A, Item 11). Thus, we anticipate that a correspondingly small number of advisers will be required to disclose new or updated disciplinary information. The Commission staff estimates that in any given year, 5% of advisers will be required to deliver a single interim update to each of their clients, resulting in a total of approximately 583 interim updates per year. 0.05 x 11,658 x 1 update = 583 updates.

delivery of each such update.[361] This represents about 130 hours per interim update.[362] Thus, the aggregate annual hour burden for affected advisers to deliver interim updates to their brochures or supplements will be approximately 75,790 hours per year.[363]

Several commenters noted that some advisers will incur costs in creating systems to track which brochure supplements need to be delivered to which clients as supervised persons providing investment advice to particular clients change over time.[364] Because most medium advisers tend to resemble small advisers in terms of the number of employees providing investment advisory services,[365] we estimate that only large advisers will need to design and implement systems to track changes in supervised persons providing investment advice to particular clients. We estimate that on average each of the 36 large advisers will spend 200 hours per year designing and implementing such systems, for a total of 7,200 hours per year.[366]

Thus, the rule amendments requiring annual delivery and interim updating of advisers' brochures and supplements yields a total collection of information burden for rule 204-3 of

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361 This burden estimate relates only to the amount of time it will take advisers to *deliver* interim updates to clients, as required by the rule amendments. The burden for *preparing* interim updates is already incorporated into the burden estimate for Form ADV discussed above. Since this mailing may not be included with a mailing of a statement or other periodic report, we estimate that it will take slightly more time than to deliver the annual brochure or summary of material changes. We also revised this estimate based on our belief that it would only take one or two minutes, not fifteen minutes to mail a brochure or summary of material changes. *See supra* note 358.

362 0.1 hours per client x 1,300 clients per adviser = 130 hours per update.

363 583 updates x 130 hours = 75,790 hours.

364 *See, e.g.*, Schwab Letter; SIFMA Letter; Sutherland Letter.

365 According to IARD data, only 4% of medium advisers report in response to Item 5.B(1) of Part 1A of Form ADV that more than 250 employees perform investment advisory functions.

366 36 large advisers x 200 hours per year per large adviser = 7,200 hours per year.

386,098 hours per year, or 33.1 hours per adviser.[367] This represents a decrease of 6,516,180 hours from the currently approved PRA burden.[368] The decreased burden results primarily from our revised estimate of the time it will take firms to deliver their brochures, supplements and amendments.

VII. COST-BENEFIT ANALYSIS

A. Background

The Commission is sensitive to the costs and benefits of its rules. This rulemaking will revise Part 2 of Form ADV to require advisers to prepare plain English narrative brochures discussing their business practices and conflicts of interest and to prepare brochure supplements discussing the background and disciplinary history of certain supervised persons who formulate investment advice or exercise investment discretion for clients. The revisions to the form also essentially move into the form itself existing rule provisions that require advisers to disclose certain disciplinary and financial information.[369]

The amendments require that advisers deliver this narrative brochure to clients at the outset of the advisory relationship and deliver an updated brochure or a summary of material changes to that brochure annually thereafter. Advisers generally will have to deliver to each client an initial brochure supplement for each supervised person who provides advisory services to that client. Advisers must deliver to clients interim updates to their brochure and brochure supplements that involve a change to disciplinary information required by Part 2. The rules provide exceptions to the brochure and supplement delivery requirements for certain types of

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367 303,108 hours (initial and annual delivery) + 75,790 hours (interim delivery of updates to disciplinary information) + 7,200 (supplement tracking systems) = 386,098 hours. 386,098 hours / 11,658 advisers = 33.1 hours per adviser.

368 6,902,278 hours – 386,098 hours = 6,516,180 hours.

369 Accordingly, the Commission is withdrawing rule 206(4)-4 as duplicative.

clients, and excuse the adviser from preparing a brochure and supplements if there is no client to whom they must be delivered. The rule amendments also require advisers to file their narrative brochures electronically through the IARD, and to keep certain records relating to the brochures and supplements.

We have identified certain costs and benefits, discussed below, that may result from the rule and form amendments. In the Proposing Release,[370] we analyzed costs and benefits of the proposed amendments to Part 2 and the related rules and requested comment and data on the effect they would have on individual investment advisers and on the advisory industry as a whole. Several commenters thought that the costs of the proposed annual brochure delivery requirement would be substantial and would not be offset by a significant corresponding benefit since they believed that few clients would read the brochure on an annual basis.[371] We note that, in response to these concerns, we have made several changes that are designed to reduce costs to advisers, including eliminating the proposed requirement for advisers to deliver an updated brochure annually to clients and instead allowing advisers to deliver to clients a summary of the material changes made to the brochure. Several commenters also argued that the Proposing Release had underestimated the costs of the brochure supplement, and urged that we not impose this disclosure requirement.[372] For many of the same reasons we discussed in the Paperwork Reduction Act section above, we are revising certain estimates of costs as described below.

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370 *See supra* note 8.

371 *See, e.g.*, Berlin Letter; CGMI Letter; FSI Letter; Jackson Letter; Merrill Lynch Letter.

372 *See supra* note 298 and accompanying text. These commenters often asserted that the costs of the supplement outweighed any benefits but did not discuss the benefits the supplement would provide to clients and how these benefits may outweigh the costs. In addition to the supplement cost estimates in the Merrill Lynch Letter and the Morgan Stanley Letter discussed above, the Schwab Letter estimated that it would cost it in excess of $5 million to design, build, and implement systems associated with supplement creation and compliance for its approximately 1,600 investment advisory representatives. The SIFMA Letter estimated that the supplement would impose industry-wide costs in excess of $100 million.

B. Form ADV Part 2 and IARD Filing

As discussed above, the revisions to Part 2 require substantially all advisers to prepare plain English narrative brochures.[373] Advisers file their brochures electronically through the IARD in a process much like attaching a file to an email.

The new narrative brochures and electronic filing provide substantial benefits to advisory clients and prospective clients. The brochures present clients with critically important information they need to determine whether to hire or continue the services of a particular adviser. This information will be presented in a uniform format easy for most investors to understand. Investors searching for an adviser will be able to access the firm's brochures through our public disclosure website even before contacting the firm, and thus will be in a better position to know whether they wish to inquire further about the services the firm is offering or conflicts raised by the adviser's business activities or practices. The narrative brochure will enable prospective clients to determine more easily whether they wish to engage an adviser that does not have certain conflicts, that does not have a disciplinary history, or that does not engage in certain business practices. The electronic availability of the brochures will provide further benefits. Clients will be able to compare business practices, strategies, and conflicts of a number of advisers, which may help them to select the most appropriate adviser for them. Third parties will be able to access adviser brochure information, which would allow academics, businesses

373 Under the amendments, advisers that are not required to deliver a brochure to clients are not required to prepare one. Advisers that provide only impersonal advice costing less than $500 per year per client, and advisers only to registered investment companies or business development companies, therefore, are not required to prepare a brochure. We estimate, based on information filed with us on Form ADV, that approximately 292 advisers provide their services only to registered investment companies and therefore would not need to prepare a brochure. Based on Form ADV filings, we estimate that 14 advisers offer advisory services only by publishing periodicals and newsletters. We estimate that approximately half of these charge less than $500 per year per client and would not need to prepare a brochure. Moreover, because advisers need not deliver supplements to clients that do not receive a brochure, these advisers also would be excused from preparing any brochure supplements.

and others to access additional information about registered investment advisers, which they can use to study the industry.

Brochure supplements will provide benefits to clients and prospective clients by providing them, for the first time, with information about the educational background, business experience, disciplinary history (if any) and conflicts of the individuals providing them with investment advice. This information will allow clients and prospective clients to determine whether there are safeguards or precautions that they would like to take before receiving investment advice from that person or whether they would prefer to receive investment advice from someone else. A prospective client could be satisfied with its selection of an advisory firm based on the firm brochure disclosures, but then determine that the firm is not the right fit once he or she reviewed the supplements of the actual individuals that would provide investment advice to him or her. Alternatively, the prospective client could retain the firm but request that other individuals provide advice in their place, potentially preventing costly or disruptive replacement or termination at a later date. This is a substantial improvement over the more limited information available today to clients and prospective clients about individuals in which clients place great trust.

To the extent that clients and prospective clients feel more confident as a result of the revised brochure that they understand the business, practices, and conflicts of an adviser, these clients may be more willing to place their trust in investment advisers, seek professional investment advice, and invest their financial assets. This could have benefits for the clients, and possibly impact capital formation and the economy.

Most commenters strongly supported the narrative, plain English format, and viewed it as a significant improvement over the current form.[374] They agreed that the new brochures would greatly benefit clients by requiring advisers to present important information about their firms in a clear and more meaningful way.[375] They observed that the enhanced disclosure required by the revised form would benefit clients by improving their ability to thoroughly evaluate advisers, their business practices and their conflicts of interest,[376] and by better equipping them with the knowledge to make informed decisions about whether to hire or retain a particular adviser.[377] Commenters also generally supported making the brochures available to the public through the Commission's website.[378]

The new amendments provide significant guidance to advisers in terms of highlighting the types of disclosures they, as fiduciaries, are already required to make. We believe the enhanced clarity provided by the new form will yield substantial benefits for advisers.

We recognize, however, that revised Part 2 also imposes costs on advisers. Advisers will be required to replace their previous Part 2 with the new narrative brochure and brochure supplements, and will be required to file their brochures electronically with us. In addition, the disclosure in the new brochure may be more extensive than what was previously required, although there is significant overlap between the items in new and old Part 2. Drafting the new narrative brochure will likely entail additional expenses. As discussed above, we believe that most of the costs that advisers will incur in connection with preparing the new narrative firm

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[374] *See supra* note 16.

[375] *See, e.g.*, ICI Letter; MMI Letter; NASAA Letter; Wellington Letter.

[376] *See, e.g.*, AICPA Letter; Janus Letter.

[377] *See* Consumer Federation Letter.

[378] *See, e.g.*, AICPA Letter; CAPIS Letter; CFA Institute Letter; CGMI Letter; Fried Frank Letter; NAPFA Letter; NASAA Letter; NRS Letter. *But see, e.g.*, Brown Letter; Wernli Letter (stating that public website disclosure of Part 2 was a violation of an adviser's privacy).

brochure and supplements will be in the initial drafting of these documents. We do not, however, expect advisers to face substantial costs in *gathering* the required disclosure. Advisers already are required to provide us and/or their clients with much of the information required in the new narrative brochure. In addition, much of the information needed for the brochure supplements can be found in an adviser's current Form ADV or an investment adviser representative's registration application (*i.e.*, Form U4) filed with state securities authorities.

The cost of preparing a narrative brochure likely will vary significantly among advisers, depending on the complexity of their operations and the choices advisers make about how to structure their disclosure given the flexibility permitted by Part 2. Some firms may choose to prepare multiple brochures for several different services. These firms likely will face only incrementally higher drafting costs than an advisory firm that uses a single brochure to make the required disclosure about the services it provides because there will be substantial overlap between the multiple brochures of such advisers. We understand that some smaller- and medium-sized firms outsource the initial preparation of their brochures to compliance consultants. These compliance consultants likely will achieve certain economies of scale in preparing many brochures complying with the new Form ADV Part 2 requirements which may lessen the costs imposed by the amendments on these advisers. Because compliance consultants work on many firms Part 2 disclosures and are familiar with industry practices generally, they will begin their review of a firm's Part 2 with more familiarity with the requirements of Part 2 and conflicts that should be addressed.

Most of the comments relating to the costs of the brochure focused not on the costs of brochure preparation, but rather on the costs of annual delivery of an updated brochure. As noted above, in the rule amendments we are adopting today, we are permitting advisers to satisfy

their annual brochure delivery obligation by delivering a summary of material changes to the brochure with information about how clients can receive the full updated brochure if they desire. This change should reduce costs significantly for advisers relating to annual brochure delivery but should improve client experiences with the disclosures they receive by focusing their attention on the material changes in the brochure. The timing of brochure and supplement delivery should allow these documents to be included in other packages that the adviser is already mailing to clients, providing additional cost savings. The primary comment we received on brochure preparation cost was that we had underestimated the time and thus costs of drafting the new narrative brochure. As noted above, we have increased this estimate in response to these comments.

Similarly, the costs of preparing brochure supplements will vary from one adviser to the next. Costs will vary most significantly depending on the number of supervised persons for whom an adviser must provide disclosure. An adviser with very few supervised persons for whom a supplement must be prepared will incur lower costs than a large adviser. Costs associated with preparing supplements also will vary greatly depending on the amount of disciplinary information, if any, required to be disclosed about a particular supervised person. Many large advisers, who will have to prepare the largest number of brochure supplements, have significant numbers of supervised persons that are also registered representatives of broker-dealers and thus may be able to reference the BrokerCheck or IAPD systems for disciplinary disclosure, which will reduce preparation costs of the supplement for these firms. The preparation of brochure supplements would be most demanding for those few advisers whose supervised persons have disciplinary records that must be disclosed, and less taxing for the vast

majority of advisers, whose supervised persons have no disciplinary records and whose supplements would therefore likely be a page or less in length.[379]

Many comments on the brochure supplement asserted that for a large adviser registered both as an investment adviser and as a broker-dealer, the supplement would impose substantial costs in creating systems to track this information among a changing group of supervised persons providing investment advice. Yet these same commenters also often stated that much of the information required by the supplement is available on FINRA's BrokerCheck system and thus collected on Form U4. Accordingly, we assume that these firms already have in place systems to track much of this information for a changing workforce (because Form U4 also must be updated as responses to its information requests change). Therefore, we believe that the supplement should impose negligible new costs in this regard since we believe these same systems could be used for supplement information tracking at negligible additional costs. We also are allowing advisers that have supervised persons with disciplinary information available through BrokerCheck or IAPD to reference that information in their electronically delivered supplements rather than reproducing that information in the supplement. This also should further decrease the costs and burdens cited by these firms in their comment letters. We do recognize, however, that large advisers may need to implement systems to track which supplements need to be provided to which clients as personnel advising clients will change from time to time. In our Paperwork Reduction Act analysis, we added an estimate of the burden for designing and implementing these systems and the cost estimate for this burden is reflected below.

379 As of May 3, 2010, IARD data indicate that in response to Item 11 in Part 1A of Form ADV, only 1,559, or 13%, of the 11,658 advisers registered with us report any disciplinary information about their firms or advisory affiliates, including their advisory employees.

We expect that only a few advisers would incur substantial costs in preparing supplements. IARD data indicate that less than one third of one percent of advisers registered with us has over 1,000 employees performing investment advisory functions on their behalf.[380] Indeed, less than five percent of our registrants have over 50 employees performing investment advisory functions. The vast majority of SEC-registered advisers – approximately 81 percent – have 10 or fewer employees performing advisory functions on their behalf. We believe most, if not all, of these firms may choose to incorporate required information about their supervised persons into their firm brochures instead of preparing separate brochure supplements, thus reducing costs of preparation.

For purposes of the Paperwork Reduction Act, we have estimated the number of hours the *average* adviser would spend in the initial preparation of its brochure and supplements.[381] Based on those estimates, we estimate that advisers would incur costs of approximately $33,639,980 in drafting these documents in the first year.[382] Furthermore, for Paperwork Reduction Act purposes we also have estimated that advisers may incur costs of approximately $22,775,400 in connection with their use of outside legal services and compliance consulting services to assist in preparation of their Form ADV.

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380 Moreover, it may not be necessary to prepare a brochure supplement for all of these employees.

381 *See* Section VI.A of this Release. Unless otherwise noted, the IARD data cited below is based on advisers' responses to questions on Part 1A of Form ADV as of May 3, 2010.

382 We expect that this function will most likely be performed by a senior compliance examiner at small firms, a compliance manager at medium firms, and a compliance attorney at large firms. Data from the Securities Industry and Financial Markets Association's *Report on Management & Professional Earnings in the Securities Industry 2008*, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead, suggest that costs for these positions are $212, $258, and $270 per hour, respectively. Based on the number of small, medium and large advisers (and assuming that the 1,000 additional advisers per year are small advisers as is typically the case), this results in a blended rate of $220 per hour. ((10,482 small advisers x $212) + (2,140 medium advisers x $258) + (36 large advisers x $270)) divided by 12,658 advisers = $220. 152,909 hours x $220 per hour = $33,639,980.

Advisers will incur annual expenses in addition to the initial costs of preparing firm brochures and supplements, but we believe these costs will be modest and similar to current costs. The rule amendments, similar to the current requirements, would require advisers to revise their disclosure documents promptly when any information in them becomes materially inaccurate, and would require advisers to update their brochures each year at the time of their required annual updating amendment. For Paperwork Reduction Act purposes, we have estimated that advisers in the aggregate would spend 87,435 hours per year on Part 2 amendments. We estimate that advisers would incur annual costs of $12,153,465 in meeting these requirements.[383] We also estimated for Paperwork Reduction Act purposes that advisers would spend some time creating brochure supplements for new employees hired each year. We estimate that advisers would incur annual costs of $1,620,462 in creating these new supplements.[384]

Finally, advisers would incur some costs in filing their brochures with us through the IARD. Advisers would prepare their brochures on their own computers and, as noted earlier, the filing of a brochure would be similar to attaching a file to an email.[385] We believe conversion of

383 We expect that preparing the amendments to Part 2 will also most likely be performed equally by compliance managers (as described in *supra* note 382) and compliance clerks. Data from the Securities Industry and Financial Markets Association's *Report on Management & Professional Earnings in the Securities Industry 2008*, modified to account for an 1,800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead, suggest that costs for a compliance clerk is $63 per hour. Blending this rate with the blended rate for a compliance manager of $215 per hour results in a cost per hour of $139. ($63 x 0.5) + ($215 x 0.5) = $139. 87,435 hours per year for amendments x $139 per hour = $12,153,465.

384 We expect that preparing the new supplements will most likely be performed equally by compliance managers (as described in *supra* note 382) and compliance clerks. The blended rate for this work is $139 per year. *See supra* note 383. 11,658 hours per year for new supplements x $139 per hour = $1,620,462.

385 We note that all advisers registered with the Commission currently file Form ADV electronically via the IARD system and, since implementation of the electronic filing requirements in 2000, no adviser has applied for a permanent hardship exemption available to advisers for whom filing electronically would constitute an undue hardship. *See* rule 203-3(b) [17 CFR 275.203-3(b)].

an adviser's brochure to PDF format and filing of that brochure through the IARD would impose minimal costs on advisers.

C. Brochure and Supplement Delivery

Advisers will be required to deliver their updated brochure or a summary of material changes in their brochure to clients annually. The amended rules require that, between annual brochure deliveries, advisers deliver brochure and supplement amendments to existing clients only if there is an addition or change to disciplinary disclosure.

Advisers already are required to deliver a copy of Part 2 to new clients. Thus, this requirement should present no new costs to advisers. Moreover, we believe that because advisers must deliver brochures to new clients, the cost of delivering brochure supplements to new clients should not increase the existing cost of delivery. Annual delivery of the updated brochures or summary of material changes in the advisers' brochures will benefit advisory clients by ensuring that they are kept apprised of material changes to their advisers' business practices and procedures for managing conflicts and will enable clients to make decisions with respect to the adviser using the most currently available information. The shorter summary will focus clients' attention on the material changes in its adviser's business practices and conflicts and, unlike the prior annual offer requirement, permit them to evaluate when they would like a full copy of the brochure or to determine whether they want to take some other action in response to the change. Previously, clients were just given notice that they could request an updated brochure. In those circumstances, the client would have to read through the entire brochure and try to determine what had changed. Many clients may have determined that this would not be a fruitful exercise and thus declined to request the brochure. Now clients will be

able to easily determine what has changed in the brochure and thus decide if they would like to take any action in response.

In addition, we believe that changes to disciplinary information disclosed in the brochure and supplements are of such importance to clients that they merit interim delivery of these amendments. This disciplinary information reflects on the integrity of the advisory firm and the individuals providing the client with advice. Given that clients entrust their financial assets and financial well being to these firms and individuals, this information is vital to clients. Moreover, advisers are already required to make disclosures regarding disciplinary information under rule 206(4)-4. Based on the experiences of examination staff, we believe that most advisers likely already make these disclosures in writing so that they can demonstrate compliance with the requirements of rule 206(4)-4 and thus are unlikely to incur additional costs as a result of this requirement. The brochure supplement will increase costs relating to *disseminating* disciplinary disclosure, but it will not impose new costs in collecting this information since firms already had to collect this information to respond to Part 1A of Form ADV. The cost of disseminating brochure supplements is reflected below.

For Paperwork Reduction Act Purposes, we have estimated that the total annual paperwork burden associated with annual and interim delivery of brochures, supplements and the summary of material changes is approximately 386,098 hours. This includes estimated time for large advisers to design and implement systems to track that the right supplements are delivered to the right clients as personnel providing investment advice to those clients change. We estimate the burden associated with annual and interim delivery of brochures, supplements and the summary of material changes would represent an annual cost of $18,918,802.[386]

386 Based on data from the Securities Industry and Financial Markets Association's *Report on Management & Professional Earnings in the Securities Industry 2008*, modified to account for an

Advisers may significantly minimize the costs associated with delivery of brochures, supplements and the summary of material changes by arranging to deliver these documents to some or all clients by electronic media.[387] Advisers also may minimize delivery costs by mailing some of these documents along with quarterly statements or other routine mailings they already send to clients. No commenters indicated the extent to which they collectively mail such documents. Our rule and form amendments do not require advisers to take advantage of any of these cost saving options—advisers alone bear this choice. Accordingly, the extent to which advisers will take advantage of these and other techniques to reduce costs is difficult to predict, but we believe it will be significant.

D. Amendments to Rule 204-2

The amendments to rule 204-2 require registered advisers to retain certain records relating to brochures and supplements. These records will benefit our examination staff by enhancing their ability to determine advisers' compliance with Form ADV's requirements. One of the revisions to the rule requires advisers to retain copies of brochure supplements and separate summaries of material changes prepared as required by Part 2. This provision generally imposes no additional costs because advisers currently are required to retain records relating to materials they distribute to their clients. Other revisions to the rule require advisers to maintain certain records in the event they use an alternative method to calculate assets under management

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1,800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead, we expect that delivery of amendments to Part 2 will also most likely be performed by a clerk at an estimated cost for a general clerk of $49 per hour. 386,098 hours x $49 = $18,918,802. We estimate that advisers will not incur any incremental postage costs in these mailings because we assume that advisers will mail annual summary of material changes with another mailing the adviser was already delivering to clients and that advisers were already delivering to clients disclosure of new material disciplinary events on an interim basis under rule 206(4)-4.

387 *See* Instruction 3 for Part 2A of Form ADV, which refers to the Commission's interpretive guidance on electronic delivery. *See also supra* note 198 for additional discussion of electronic delivery.

in response to Item 4.E of Part 2A and if they do not disclose in their brochure a presumptively material legal or disciplinary event listed in Item 9 of Part 2A or Item 3 of Part 2B. These provisions benefit advisers by permitting them flexibility in drafting their firm brochures and supplements while providing for maintenance of records needed by our examination staff. Because we anticipate that only a relatively small number of advisers will be subject to these provisions, we expect that the cost of maintaining these records will be relatively minimal. We estimate that advisers would incur annual costs of $595,280 in meeting these requirements.[388]

VIII. FINAL REGULATORY FLEXIBILITY ANALYSIS

We have prepared this Final Regulatory Flexibility Analysis (FRFA) in accordance with section 4(a) of the Regulatory Flexibility Act (RFA).[389] It relates to the amendments to rules 203-1, 204-1, 204-2, 204-3, and 206(4)-4, and Form ADV under the Advisers Act. The rule and form amendments are designed to improve the disclosure that investment advisers provide to their clients. These amendments also revise the instructions for updating and filing Form ADV (including adviser brochures). We also are adopting conforming rule amendments that revise the recordkeeping requirements relating to Part 2 of Form ADV.

We included in the Proposing Release an Initial Regulatory Flexibility Analysis (IFRA). We received no comments specifically on that IRFA.

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388 For Paperwork Reduction Act purposes we estimate that only 506 advisers will be required to prepare additional records in accordance with the amendment to rule 204-2 and that each adviser would spend approximately four hours to satisfy the obligation for a total burden of 2,024 hours per year and that such advisers will incur $150,000 per year in outside legal expenses relating to such records. We expect that preparing the records will most likely be performed by compliance managers (as described in *supra* note 382). 2,024 hours x $220 per hour = $445,280. $445,280 + $150,000 = $595,280.

389 5 U.S.C. 604(a).

A. Need for the Rule and Form Amendments

The rule and form amendments are necessary to improve the quality of disclosure that advisers provide to their clients.[390] Form ADV with its two parts was adopted by the Commission in 1979 and advisers use it to register with the Commission (Part 1A) and to provide clients disclosure about their advisory firm and personnel (Part 2).[391] Over the years, however, experience has shown that the format and content of the previous Part 2 of Form ADV did not lend themselves to disclosure that is easy for clients to understand. Clients need clearer information about an adviser's services, fees, business practices, and conflicts of interests to be able to make an informed decision about whether to hire or retain that adviser.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the IRFA. None of the comment letters specifically addressed the IRFA. A few commenters made specific comments about the proposed rule and form amendments' impact on smaller advisers. One commenter was concerned that disclosure of assets under management and financial information would unduly discriminate against smaller advisers.[392] As we discussed above with respect to Item 18 of Part 2, we believe that a client that becomes a creditor of an adviser because it prepays fees would want information about the adviser's financial condition. In addition, this information is currently required to be disclosed to clients, and the commenter did not persuade us that it should be omitted. Another commenter stated that Item 8's requirement that advisers primarily using a particular strategy discuss the risks involved in its strategy discriminates against smaller firms

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390 Sections I through IV of this Release describe in more detail the reasons for the amendments.

391 *See* 1979 Adopting Release, *supra* note 6.

392 Verbeck Letter.

who are less likely to be multi-strategy firms.[393] As discussed earlier in this Release,[394] we agree that advisers should disclose material risks associated with their strategies, regardless of whether they use one strategy or many strategies but believe that the brochure may not always be the best place for a multi-strategy adviser to disclose these risks. Another commenter suggested that we permit smaller advisers to provide short-form brochures.[395] As discussed earlier in the release,[396] we have not determined to shorten the brochure for any type of advisers because we believe that the brochure contains important information upon which clients rely and much of which advisers are already required to make to satisfy their fiduciary duty to their clients. We have, however, allowed advisers to satisfy their annual brochure delivery obligation by delivering a summary of material changes in their brochure to their clients.

C. Small Entities Subject to the Rules

In developing the amendments, we have considered their potential impact on small entities that may be affected. The rule and form amendments will affect all advisers registered with the Commission, including small entities. Under Commission rules, for purposes of the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets

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393 NAPFA Letter.

394 *See supra* notes 71-75 and accompanying text.

395 NSCP Letter.

396 *See supra* notes 25-28 and accompanying text.

under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[397]

Our rule and form amendments will not affect most advisers that are small entities ("small advisers") because they are generally registered with one or more state securities authorities and not with us. Under section 203A of the Advisers Act, most small advisers are prohibited from registering with the Commission and are regulated by state regulators.[398] The Commission estimates that as of May 3, 2010, of the 11,658 registered with us, there were approximately 708 that were small entities that would be affected by the amendments.[399]

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The rule and form amendments impose certain reporting and compliance requirements on small advisers, requiring them to create and update narrative brochures containing certain information regarding their advisory business. The amendments also require advisers to deliver their brochures to clients and to file them electronically through the IARD. The amendments also impose new recordkeeping requirements. These requirements and the burdens on small advisers are discussed below.[400]

1. Amendments to Part 2 of Form ADV

The amendments to Part 2, because they require registered advisers to prepare and disseminate narrative brochures, impose additional costs on all registered advisers, including

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397 *See* rule 0-7 [17 CFR 275.0-7].

398 National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290, 110 Stat. 3438) (1996) ("NSMIA"). As a result of NSMIA, advisers with less than $25 million of assets under management generally are regulated by one or more state securities authority, while the Commission generally regulates those advisers with at least $25 million of assets under management. *See* section 203A of the Advisers Act [15 USC 80b-3a].

399 This estimate is based on information advisers have filed with the Commission on Part 1A of Form ADV as of May 3, 2010.

400 Sections I through IV of this Release describe these requirements in more detail.

small advisers. We assume that all small advisers previously distributed Part 2 of Form ADV and did not draft the optional narrative brochure. If our assumption is correct, these advisers would have to redraft their brochures completely to comply with the new format, although a lot of information in the previous Part 2 will be transferable to the new narrative brochures.

The costs associated with preparing the new brochures will depend on the size of the adviser, the complexity of its operations, and the extent to which its operations present conflicts of interest with clients. Many of the new items imposing the most rigorous disclosure requirements may not apply to certain small advisers because, for example, those advisers may not have soft dollar or directed brokerage arrangements, or may not have custody of client assets. However, certain of the brochure compliance costs may be fixed and thus impose a disproportionate impact on small advisers. To the extent that some of the new disclosure burdens would apply to small advisers, these advisers are already obligated to make the disclosures to clients under the Advisers Act's antifraud provisions, although the disclosure currently is not required to be in the firm's written brochure.

For the first time, advisers also will be required to prepare and disseminate brochure supplements for certain supervised persons of their firm. To reduce the burdens on small advisers, however, we have drafted the new supplement rules so that firms with few employees would be permitted to include supplement information in their firm brochures and may choose to avoid preparing and distributing separate brochure supplements. We believe many small advisers would take advantage of this option and reduce their compliance burden. We also note that small advisers are unlikely to have many supervised persons for whom a brochure supplement is required, so the supplement should impose a proportionately smaller burden on small advisers. The rule amendments may increase compliance costs for investment advisers.

Certain of these increased compliance costs attributable to supplements may be fixed and thus impose a disproportionate impact on small advisers.

2. Updating and Delivery Requirements

The amended rules, like the prior rules, require advisers to update their brochures and supplements whenever information in them becomes materially inaccurate. In updating its brochure and supplements on an interim basis, an adviser may minimize its burden by delivering a statement describing this updated information instead of reprinting its entire brochure or supplement.

The amendments require advisers to deliver an updated brochure or a summary of material changes in the adviser's brochure to clients annually and to deliver interim updates of the brochure and supplements to clients to disclose new or revised disciplinary information. To minimize the burden of delivery, advisers are permitted with client consent to deliver brochures, supplements and the summary of material changes, as well as updates, electronically.[401] To the extent that small advisers are more likely to have fewer advisory clients than larger advisers, the delivery requirements should impose lower costs on small advisers than on larger firms.

3. Recordkeeping Requirements

The amendments impose new recordkeeping requirements on advisers, including small advisers. As under the previous rules, advisers will be required to maintain copies of their brochures. The amendments also require all advisers to maintain copies of their brochure supplements. Advisers will be required to maintain a copy of any summary of material changes in their brochure that is separate from the brochure. In addition, the amendments require advisers, including small advisers, to maintain certain records if they determine that a

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[401] *See supra* notes 196-198.

disciplinary event that is presumptively material does not have to be disclosed, or if they calculate their managed assets for purpose of their brochures differently than in Part 1A of Form ADV.

E. Agency Action to Minimize Effect on Small Entities

We have considered various alternatives in connection with the rule and form amendments that might minimize their effect on small advisers, including: (i) establishing different compliance or reporting requirements or timetables that take into account the resources available to small advisers; (ii) clarifying, consolidating, or simplifying compliance and reporting requirements under the proposed amendments for small advisers; (iii) using performance rather than design standards; and (iv) exempting small advisers from coverage of all or part of the proposed amendments.

Regarding the first alternative, the Commission believes that establishing different compliance or reporting requirements for small advisers would be inappropriate under these circumstances. The amendments are designed to improve the quality and timeliness of critically important disclosure that advisory clients receive from their advisers. To establish different disclosure requirements for small entities would diminish this investor protection for clients of small advisers. We note, however, that small advisers, by the nature of their business, likely would spend fewer resources in completing their brochures and any brochure supplements. Small advisers have few supervised persons providing investment advice, so they will need to prepare few brochure supplements. Moreover, certain rule and form amendments were designed specifically to reduce the burden on small advisers. For example, the Part 2 instructions give advisers the flexibility to incorporate required information about their supervised persons into their firm brochures rather than presenting it in separate brochure supplements, thereby saving additional printing and mailing costs.

Regarding the second alternative, the amendments clarify requirements for all advisers, including small advisers. The amended Part 2 instructions are designed to present requirements for advisers' brochures and supplements clearly and simply to all advisers, including small entities.

Regarding the third alternative, the Commission believes that the amendments already appropriately use performance rather than design standards in many instances. The amendments permit advisers flexibility in designing their brochures and supplements so as best to communicate the required information to clients. In preparing brochure supplements, advisers also have the flexibility of adapting the format of the supplements to best suit their firm. An adviser may: (i) prepare a separate supplement for each supervised person; (ii) prepare a single supplement containing the required information for all of its supervised persons; (iii) prepare multiple supplements for groups of supervised persons (*e.g.*, all supervised persons in a particular office or work group); or (iv) include all information about supervised persons in the firm brochure and prepare no separate supplements.[402] The amendments clarify that advisers may, with client consent, deliver their brochures and supplements, along with any updates, to clients electronically.[403] Advisers may incorporate their supplements into the brochure or provide them separately.

Regarding the fourth alternative, it would be inconsistent with the purposes of the Advisers Act to exempt small advisers from the rule and form amendments. The information in an adviser's brochure is necessary for the client to evaluate the adviser's services, fees, and business practices, and to apprise the client of potential conflicts of interest and, when necessary,

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402 *See* Section II.B of this Release. A brochure supplement, however, must be organized in the same order, and use the same headings, as the items appear in the form, whether incorporated in a brochure or provided separately. *See* Instruction 1 of General Instructions for Part 2 of Form ADV.

403 *See supra* notes 196-198.

of the adviser's financial condition. Since we view the protections of the Advisers Act to apply equally to clients of both large and small advisers, it would be inconsistent with the purposes of the Act to specify different requirements for small entities.

IX. EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition, and 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.[404] Section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[405] Section 202(c) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[406]

In the Proposing Release, we solicited comment on whether, if adopted, the proposed rule and form amendments would promote efficiency, competition and capital formation. We further encouraged commenters to provide empirical data to support their views on any burdens on efficiency, competition or capital formation that might result from adoption of the proposed amendments. We did not receive any empirical data in this regard concerning the proposed amendments. We received one comment stating that the proposed amendments would not

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404 15 U.S.C. 78w(a)(2).

405 15 U.S.C. 78c(f).

406 15 U.S.C. 80b-2(c).

promote efficiency, competition, and capital formation, but the commenter did not state why.[407] Accordingly, since the adopted rule and form amendments are similar to the proposed rule and amendments, we continue to believe the amendments will contribute to efficiency, competition and capital formation.

Today the Commission is adopting amendments to Part 2 of Form ADV and related Advisers Act rules that would require investment advisers registered with us to deliver to clients and prospective clients brochures and brochure supplements written in plain English. We believe that the rule and form amendments that we are adopting today are likely to promote efficiency and competition in the marketplace for advisory services provided by advisers registered with us by improving the disclosure that they must provide to clients.[408] These amendments are designed to require advisers to provide clients and prospective clients with clear, current, and more meaningful disclosure of the business practices, conflicts of interest, and background of investment advisers and the advisory personnel on whom clients rely for

407 Jackson Letter. Another commenter stated that the requirement to disclose the amount of assets under management in the brochure would discriminate against smaller firms because of a perceived notion that a larger company does a better job. *See* Verbeck Letter. As discussed at *supra* 181 and accompanying text, assets under management is an objective measure that provides important information to clients. Clients have different preferences and some, for example, may view a smaller adviser as being more likely to provide more personal service. In addition, the NAPFA Letter stated that Item 8's requirement that advisers primarily using a particular strategy discuss the risks involved in its strategy discriminates against smaller firms who are less likely to be multi-strategy firms. As discussed at *supra* notes 72-75 and accompanying text, we disagree.

408 Along with the brochure amendments, the Commission also is adopting conforming amendments to the General Instructions and Glossary of Form ADV to include instructions regarding brochure filing requirements and to add glossary terms and definitions that are used in Part 2. Additionally, the Commission also is adopting conforming amendments to the Advisers Act books and records rule. These amendments require advisers to maintain copies of their brochures, brochure supplements, amendments, and summaries of material changes, and are intended to update the books and records rule in light of our changes to Part 2. None of these conforming amendments are expected to have an independent impact on efficiency, competition, or capital formation. To the extent that they facilitate the purposes of the amendments, the conforming amendments may, however, contribute to the expected effects on efficiency, competition and capital formation that would stem from the amendments and which are discussed below.

investment advice. As a result, we believe that advisory clients will be provided with improved disclosure from advisers that will allow them to select an adviser based on a clearer and more thorough understanding of the business practices, conflicts of interest, and disciplinary information than exists with the check-the-box format of the current brochure. While advisers currently have the option of providing a narrative brochure, few do so. Absent the actions we are taking today, based on our experience with administering the Advisers Act brochure requirement and inefficiencies in the marketplace, we do not believe that advisers have adequate incentives to produce clear and understandable brochures. We expect the amendments we are adopting today, by requiring clearer and more understandable brochures, are likely to increase competition among advisers.

Advisers will file their brochures with us electronically, and we will make them available to the public through our website. Today, while advisers' brochures are "deemed" filed with us, it is difficult for the public to obtain them unless the adviser provides a brochure upon request or makes it available on its own website, which also makes it very difficult for prospective clients to compare more than a few investment advisers. With the public availability through our website of more thorough and current disclosure of advisers' services, fees, business practices and conflicts of interests, investors will be able to make more informed decisions about whether to hire or retain a particular adviser and will have an easier time comparing investment advisers. The supplements will allow clients and prospective clients to compare the qualifications and conflicts not only of the advisory firm but also of the personnel that will be providing investment advice to them. By having more information about the individuals and firms providing investment advice to them, as well as the ability to compare advisory firms, a client may be more likely to select initially an appropriate investment adviser for that client, promoting competition

on the basis of improved disclosure of conflicts of interest and business practices and avoiding the burdens and costs associated with switching advisers or supervised persons at a later date, and thereby potentially creating efficiency gains in the marketplace. The availability of this information about advisers and their personnel also may enhance competition if, for example, firms and personnel with better disciplinary records outcompete those with worse records. Secondarily, the electronic filing requirements are expected to expedite and simplify the process of filing firm brochures and amendments for the advisory firms, thus improving the efficiency of advisers that are required to file and update the brochure.

A few commenters stated that certain information required to be disclosed in the brochure is duplicative of information required to be reported in Part 1A of Form ADV and that such information should only be required disclosure in one place in Form ADV.[409] While we are conscious of these commenters' goal of generating efficiency by eliminating duplicative disclosure in Form ADV, we do not believe that it is appropriate to allow disclosure in Part 1A to satisfy disclosure obligations in Part 2B, or vice versa, because, these parts serve different functions and clients and prospective clients access these documents in different ways. Part 1A is used for regulatory purposes and thus the information it collects is that which our examination staff has identified as important for us to have for our examination program and other regulatory functions. While an adviser's responses to Part 1A of Form ADV generally are available to the public through our website, they are not delivered to clients or prospective clients and they are not written in a manner designed to be meaningful to clients or prospective clients – rather they are largely a series of "check-the-box" responses. Part 2A of Form ADV, on the other hand, is disclosure aimed at and delivered to clients and prospective clients. Accordingly, while certain

409 *See, e.g.*, ACLI Letter; IAA Letter.

topics of disclosure may be covered by both parts, we believe the different functions of, and delivery methods for, these two parts justifies the replication of disclosure topics.

On the other hand, the amendments we are adopting today are designed to generate efficiencies and reduce duplicative disclosure by allowing an adviser who sends supplements electronically, and whose supervised persons have disciplinary disclosure available on FINRA's BrokerCheck system or the IAPD system, to respond to those portions of Item 3 of the brochure supplement by including in the brochure supplement (i) a statement that the supervised person has a disciplinary history, the details of which can be found on FINRA's BrokerCheck system or the IAPD, and (ii) a hyperlink to the relevant system with a brief explanation of how the client can access the disciplinary history. In this instance, we believe that permitting cross-referencing is appropriate since it will only be allowed if the supplement is delivered electronically and the disclosure is duplicative. The BrokerCheck and IAPD systems are aimed at investor disclosure and are designed to be user-friendly, and clients will still receive delivery of a supplement which contains the other information (*e.g.*, educational background and other business activities) about that supervised person.

In addition to the competitive impact mentioned above, we believe that the rule amendments may have certain other impacts on competition. The brochure supplement may impose greater costs on larger advisers that have to create systems to track appropriate delivery of supplements that smaller advisers would not need. To the extent these costs are passed on to clients, a client's choice of investment advisers may be impacted. As we noted in the Cost-Benefit Analysis section above, however, many of these systems costs should be mitigated by systems that large advisers already have in place to track Form U4 information for their investment advisory representatives and broker-dealer registered representatives, which these

firms should be able to leverage for use in the brochure supplement context. The rule amendments also may increase compliance costs for investment advisers. Certain of these increased compliance costs may be fixed and thus impose a disproportionate impact on small advisers, which may have anticompetitive impacts on small advisers.

The competitive impacts discussed previously primarily focused on the impact of the rule amendments on investment advisers that are registered with us. We acknowledge that there may also be competitive impacts as a result of the amendments between those persons providing investment advice that are, and those that are not, registered with us as investment advisers. For example, banks, insurance companies, broker-dealers, and exempt advisers provide financial services that may compete, in some cases, for the same clients that would retain SEC-registered investment advisers. We have carefully considered the potential competitive implications of these rule amendments and do not believe that they will put advisers registered with us at a significant competitive disadvantage. Moreover, notwithstanding the potential competitive effect, we believe that the concerns that the amendments are designed to address justify adoption of the rule amendments. Pursuant to Section 23(a)(2) of the Exchange Act, the Commission does not believe that the amendments to Form ADV impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

As stated previously, the rule amendments are designed to provide advisory clients with clearer, more concise and understandable information regarding the business practices and conflicts of interest of investment advisers. Improved disclosure by SEC-registered investment advisers could result in enhanced efficiencies for clients in selecting an investment adviser and improved allocation of client assets among investment advisers. To a more limited extent, if better disclosure increases clients' and prospective clients' trust in investment advisers, it may

encourage them to seek professional investment advice and encourage them to invest their financial assets. This also may enhance capital formation by making more funds available for investment and enhancing the allocation of capital generally. On the other hand, if the rule amendments increase costs at investment advisers and these costs increases are passed on to clients, this may deter clients from seeking professional investment advice and investing their financial assets. This may result in inefficiencies in the market for advisory services and hinder capital formation.

X. STATUTORY AUTHORITY

We are adopting amendments to rule 203-1 under sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)].

We are adopting amendments to rule 204-1 under sections 203(c)(1) and 204 of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1) and 80b-4].

We are adopting amendments to rule 204-2 under sections 204 and 206(4) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-4 and 80b-6(4)].

We are adopting amendments to rule 204-3 under sections 204, 206(4), and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-4, 80b-6(4), and 80b-11(a)].

We are adopting amendments to rule 279.1, Form ADV, under section 19(a) of the Securities Act of 1933 [15 U.S.C. 77s(a)], sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934 [15 U.S.C. 78w(a) and 78bb(e)(2)], section 319(a) of the Trust Indenture Act of 1939 [15 U.S.C. 77sss(a)], section 38(a) of the Investment Company Act of 1940 [15 U.S.C. 78a-37(a)], and sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)].

We are removing and reserving rule 206(4)-4 under section 206(4) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-6(4)].

List of Subjects in 17 CFR Parts 275 and 279

Reporting and recordkeeping requirements; Securities

TEXT OF RULE AND FORM AMENDMENTS

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

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

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

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

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2. Section 275.203-1 is amended by revising paragraphs (a) and (b) to read as follows:

§ 275.203-1 Application for investment adviser registration.

(a) Form ADV. Subject to paragraph (b), to apply for registration with the Commission as an investment adviser, you must complete Form ADV [17 CFR 279.1] by following the instructions in the form and you must file Part 1A of Form ADV and the firm brochure(s) required by Part 2A of Form ADV electronically with the Investment Adviser Registration Depository (IARD) unless you have received a hardship exemption under § 275.203-3. You are not required to file with the Commission the brochure supplements required by Part 2B of Form ADV.

(b) Transition to electronic filing. If you apply for registration after January 1, 2011, you must file a brochure(s) that satisfies the requirements of Part 2A of Form ADV electronically with the IARD, unless you have received a continuing hardship exemption under § 275.203-3.

Note to paragraph (a) and (b): Information on how to file with the IARD is available on the Commission's website at www.sec.gov/iard. If you are not required to deliver a brochure to any clients, you are not required to prepare or file a brochure with the Commission. If you are not required to deliver a brochure supplement to any clients for any particular supervised person, you are not required to prepare a brochure supplement for that supervised person..

* * * * *

3. Section 275.204-1 is amended by removing the notes to paragraphs (a) and (c) and revising paragraphs (b) and (c) to read as follows:

§ 275.204-1 Amendments to application for registration.

* * * * *

(b) Electronic filing of amendments.

(1) Subject to paragraph (c), you must file all amendments to Part 1A of Form ADV and Part 2A of Form ADV electronically with the IARD, unless you have received a continuing hardship exemption under § 275.203-3. You are not required to file with the Commission amendments to brochure supplements required by Part 2B of Form ADV.

(2) If you have received a continuing hardship exemption under §275.203-3, you must, when you are required to amend your Form ADV, file a completed Part 1A and Part 2A of Form ADV on paper with the SEC by mailing it to FINRA.

Note to paragraphs (a) and (b): Information on how to file with the IARD is available on our website at www.sec.gov/iard. For the annual updating amendment: (i) summaries of material changes that are not included in the adviser's brochure must be filed with the Commission as an exhibit to Part 2A in the same electronic file; and (ii) if you are not required to prepare a

summary of material changes or an annual updating amendment to your brochure, you are not required to file them with the Commission. See the instructions for Part 2A of Form ADV.

(c) Transition to electronic filing. If your fiscal year ends on or after December 31, 2010, you must amend your Form ADV by electronically filing with the IARD one or more brochures that satisfy the requirements of Part 2A of Form ADV (as amended effective [INSERT EFFECTIVE DATE OF RULES/FORM]) as part of the next annual updating amendment that you are required to file.

* * * * *

4. Section 275.204-2is amended by revising paragraph (a)(14) to read as follows:

§ 275.204-2 Books and records to be maintained by investment advisers.

(a) * * *

(14)(i) A copy of each brochure and brochure supplement, and each amendment or revision to the brochure and brochure supplement, that satisfies the requirements of Part 2 of Form ADV [17 CFR 279.1]; any summary of material changes that satisfies the requirements of Part 2 of Form ADV but is not contained in the brochure; and a record of the dates that each brochure and brochure supplement, each amendment or revision thereto, and each summary of material changes not contained in a brochure was given to any client or to any prospective client who subsequently becomes a client.

(ii) Documentation describing the method used to compute managed assets for purposes of Item 4.E of Part 2A of Form ADV, if the method differs from the method used to compute assets under management in Item 5.F of Part 1A of Form ADV.

(iii) A memorandum describing any legal or disciplinary event listed in Item 9 of Part 2A or Item 3 of Part 2B (Disciplinary Information) and presumed to be material, if the event involved the investment adviser or any of its supervised persons and is not disclosed in the

brochure or brochure supplement described in paragraph (a)(14)(i) of this section. The memorandum must explain the investment adviser's determination that the presumption of materiality is overcome, and must discuss the factors described in Item 9 of Part 2A of Form ADV or Item 3 of Part 2B of Form ADV.

* * * * *

5. Section 275.204-3 is revised to read as follows:

§ 275.204-3 Delivery of brochures and brochure supplements.

(a) General requirements. If you are registered under the Act as an investment adviser, you must deliver a brochure and one or more brochure supplements to each client or prospective client that contains all information required by Part 2 of Form ADV [17 CFR 279.1].

(b) Delivery requirements. Subject to paragraph (g), you (or a supervised person acting on your behalf) must:

(1) Deliver to a client or prospective client your current brochure before or at the time you enter into an investment advisory contract with that client.

(2) Deliver to each client, annually within 120 days after the end of your fiscal year and without charge, if there are material changes in your brochure since your last annual updating amendment:

(i) A current brochure, or

(ii) The summary of material changes to the brochure as required by Item 2 of Form ADV, Part 2A that offers to provide your current brochure without charge, accompanied by the website address (if available) and an e-mail address (if available) and telephone number by which a client may obtain the current brochure from you, and the website address for

obtaining information about you through the Investment Adviser Public Disclosure (IAPD) system.

(3) Deliver to each client or prospective client a current brochure supplement for a supervised person before or at the time that supervised person begins to provide advisory services to the client; provided, however, that if investment advice for a client is provided by a team comprised of more than five supervised persons, a current brochure supplement need only be delivered to that client for the five supervised persons with the most significant responsibility for the day-to-day advice provided to that client. For purposes of this section, a supervised person will provide advisory services to a client if that supervised person will:

(i) Formulate investment advice for the client and have direct client contact; or

(ii) Make discretionary investment decisions for the client, even if the supervised person will have no direct client contact.

(4) Deliver the following to each client promptly after you create an amended brochure or brochure supplement, as applicable, if the amendment adds disclosure of an event, or materially revises information already disclosed about an event, in response to Item 9 of Part 2A of Form ADV or Item 3 of Part 2B of Form ADV (Disciplinary Information), respectively, (i) the amended brochure or brochure supplement, as applicable, along with a statement describing the material facts relating to the change in disciplinary information, or (ii) a statement describing the material facts relating to the change in disciplinary information.

(c) Exceptions to delivery requirement.

(1) You are not required to deliver a brochure to a client:

(i) That is an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 to 80a-64] or a business development company as defined in that Act, provided that the advisory contract with that client meets the requirements of section 15(c) of that Act [15 U.S.C. 80a-15(c)]; or

(ii) Who receives only impersonal investment advice for which you charge less than $500 per year.

(2) You are not required to deliver a brochure supplement to a client:

(i) To whom you are not required to deliver a brochure under subparagraph (c)(1) of this section;

(ii) Who receives only impersonal investment advice; or

(iii) Who is an officer, employee, or other person related to the adviser that would be a "qualified client" of your firm under § 275.205-3(d)(1)(iii).

(d) Wrap fee program brochures.

(1) If you are a sponsor of a wrap fee program, then the brochure that paragraph (b) of this section requires you to deliver to a client or prospective client of the wrap fee program must be a wrap fee program brochure containing all the information required by Part 2A, Appendix 1 of Form ADV. Any additional information in a wrap fee program brochure must be limited to information applicable to wrap fee programs that you sponsor.

(2) You do not have to deliver a wrap fee program brochure if another sponsor of the wrap fee program delivers, to the client or prospective client of the wrap fee program, a wrap fee program brochure containing all the information required by Part 2A, Appendix 1 of Form ADV.

Note to paragraph (d): A wrap fee program brochure does not take the place of any brochure supplements that you are required to deliver under paragraph (b) of this section.

(e) Multiple brochures. If you provide substantially different advisory services to different clients, you may provide them with different brochures, so long as each client receives all information about the services and fees that are applicable to that client. The brochure you deliver to a client may omit any information required by Part 2A of Form ADV if the information does not apply to the advisory services or fees that you will provide or charge, or that you propose to provide or charge, to that client.

(f) Other disclosure obligations. Delivering a brochure or brochure supplement in compliance with this section does not relieve you of any other disclosure obligations you have to your advisory clients or prospective clients under any federal or state laws or regulations.

(g) Transition rule.

(1) Within 60 days after the date by which you are first required by § 275.204-1(c) to electronically file your brochure(s) with the Commission, you must deliver to each of your existing clients your current brochure and all current brochure supplements as required by Part 2 of Form ADV.

(2) As of the date by which you are first required to electronically file your brochure(s) with the Commission, you must begin using your current brochure and current brochure supplements as required by Part 2 of Form ADV to comply with the requirements of this section pertaining to initial delivery to new and prospective clients.

(h) Definitions. For purposes of this section:

(1) Impersonal investment advice means investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts.

(2) Current brochure and current brochure supplement mean the most recent revision of the brochure or brochure supplement, including all amendments to date.

(3) Sponsor of a wrap fee program means an investment adviser that is compensated under a wrap fee program for sponsoring, organizing, or administering the program, or for selecting, or providing advice to clients regarding the selection of, other investment advisers in the program.

(4) Supervised person means any of your officers, partners or directors (or other persons occupying a similar status or performing similar functions) or employees, or any other person who provides investment advice on your behalf.

(5) Wrap fee program means an advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions.

6. Section 275.206(4)-4 is removed and reserved.

* * * * *

PART 279 -- FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

7. The authority citation for Part 279 continues to read as follows:

Authority: 15 U.S.C. 80b-1, *et seq.*

8. Form ADV [referenced in § 279.1] is amended by:

a. In the instructions to the form, revising the section entitled "Form ADV: General Instructions." The revised version of Form ADV: General Instructions is attached as Appendix A;

b. In the instructions to the form, revising the section entitled "Glossary of Terms." The revised version of Glossary of Terms is attached as Appendix B; and

c. Removing Form ADV, Part II, and adding Form ADV, Part 2. Form ADV, Part 2 is attached as Appendix C.

Note: The text of Form ADV does not and the amendments will not appear in the Code of Federal Regulations.

* * * * *

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

July 28, 2010

Appendix A

FORM ADV (Paper Version)
UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

Form ADV: General Instructions

Read these instructions carefully before filing Form ADV. Failure to follow these instructions, properly complete the form, or pay all required fees may result in your application being delayed or rejected.

In these instructions and in Form ADV, "you" means the investment adviser (i.e., the advisory firm) applying for registration or amending its registration. If you are a "separately identifiable department or division" (SID) of a bank, "you" means the SID, rather than your bank, unless the instructions or the form provide otherwise. Terms that appear in *italics* are defined in the Glossary of Terms to Form ADV.

1. Where can I get more information on Form ADV, electronic filing, and the IARD?

The SEC provides information about its rules and the Advisers Act on its website: <http://www.sec.gov/iard>.

NASAA provides information about state investment adviser laws and state rules, and how to contact a *state securities authority*, on its website: <http://www.nasaa.org>.

FINRA provides information about the IARD and electronic filing on the IARD website: <http://www.iard.com>.

2. What is Form ADV used for?

Investment advisers use Form ADV to:

- Register with the Securities and Exchange Commission
- Register with one or more *state securities authorities*
- Amend those registrations

3. How is Form ADV organized?

Form ADV contains four parts:

- Part 1A asks a number of questions about you, your business practices, the *persons* who own and *control* you, and the *persons* who provide investment advice on your behalf. All advisers registering with the SEC or any of the *state securities authorities* must complete Part 1A.

Part 1A also contains several supplemental schedules. The items of Part 1A let you know which schedules you must complete.

- Schedule A asks for information about your direct owners and executive officers.
- Schedule B asks for information about your indirect owners.
- Schedule C is used by paper filers to update the information required by Schedules A and B (see Instruction 14).
- Schedule D asks for additional information for certain items in Part 1A.
- Disclosure Reporting Pages (or DRPs) are schedules that ask for details about disciplinary events involving you or your *advisory affiliates*.

- Part 1B asks additional questions required by *state securities authorities*. Part 1B contains three additional DRPs. If you are applying for registration or are registered only with the SEC, you do not have to complete Part 1B. (If you are filing electronically and you do not have to complete Part 1B, you will not see Part 1B.)

- Part 2A requires advisers to create narrative *brochures* containing information about the advisory firm. The requirements in Part 2A apply to all investment advisers registered with or applying for registration with the SEC. If you are registered with or applying for registration with one or more of the *state securities authorities*, you should contact the appropriate *state securities authorities* to determine whether the requirements in Part 2A apply to you.

- Part 2B requires advisers to create *brochure supplements* containing information about certain *supervised persons*. The requirements in Part 2B apply to all investment advisers registered with or applying for registration with the SEC. If you are registered with or applying for registration with one or more of the *state securities authorities*, you should contact the appropriate *state securities authorities* to determine whether the requirements in Part 2B apply to you.

4. When am I required to update my Form ADV?

You must amend your Form ADV each year by filing an *annual updating amendment* within 90 days after the end of your fiscal year. When you submit your *annual updating amendment*, you must update your responses to all items. You must submit your summary of material changes required by Item 2 of Part 2 either in the *brochure* (cover page or the page immediately thereafter) or as an exhibit to your *brochure*.

In addition to your *annual updating amendment*, you must amend your Form ADV by filing additional amendments (other-than-annual amendments) <u>promptly</u> if:

- information you provided in response to Items 1, 3, 9 (except 9.A.(2), 9.B.(2), and 9.(E)), or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2.I. of Part 1B becomes inaccurate in any way;

- information you provided in response to Items 4, 8, or 10 of Part 1A or Item 2.G. of Part 1B becomes materially inaccurate; or

- information you provided in your *brochure* becomes materially inaccurate (see note below for exceptions).

Notes: Part 1: If you are submitting an other-than-annual amendment, you are not required to update your responses to Items 2, 5, 6, 7, 9.A.(2), 9.B.(2), 9.E., or 12 of Part 1A or Items 2.H. or 2.J. of Part 1B even if your responses to those items have become inaccurate.

Part 2: You must amend your *brochure supplements* (see Form ADV, Part 2B) promptly if any information in them becomes materially inaccurate. If you are submitting an other-than-annual amendment to your brochure, you are not required to update your summary of material changes as required by Item 2. You are not required to update your *brochure* between annual amendments solely because the amount of *client* assets you manage has changed or because your fee schedule has changed. However, if you are updating your *brochure* for a separate reason in between annual amendments, and the amount of *client* assets you manage listed in response to Item 4.E or your fee schedule listed in response to Item 5.A has become materially inaccurate, you should update that item(s) as part of the interim amendment.

- If you are an SEC-registered adviser, you are required to file your brochure amendments electronically through IARD. You are not required to file amendments to your brochure supplements with the SEC, but you must maintain a copy of them in your files.

- If you are a state-registered adviser, you are required to file your *brochure* amendments and *brochure supplement* amendments with the appropriate *state securities authorities through IARD.*

Failure to update your Form ADV, as required by this instruction, is a violation of SEC rule 204-1 or similar state rules and could lead to your registration being revoked.

5. Part 2 of Form ADV was amended recently. When do I have to comply with the new requirements?

If you are applying for registration with the SEC:

- Beginning January 1, 2011, your application for registration must include a narrative *brochure* prepared in accordance with the requirements of (amended) Part 2A of Form ADV. See SEC rule 203-1. After that date, the SEC will not accept any application that does not include a *brochure*(s) that satisfies the requirements of (amended) Part 2 of Form ADV.

- Until that date, you may (but are not required to) include in your application a narrative *brochure* that meets the requirements of (amended) Part 2A of Form ADV. If you do not do this, you must comply with the requirements for preparing, delivering, and offering "old" Part II of Form ADV.

If you already are registered with or have submitted an application for registration with the SEC:

- If your fiscal year ends on or after December 31, 2010, you must amend your Form ADV to add a narrative *brochure* that meets the requirements of (amended) Part 2A of Form ADV when you file your next *annual updating amendment*.

- Until that date, you may (but are not required to) submit a narrative *brochure* that meets the requirements of (amended) Part 2A of Form ADV. If you do not do this, you must continue to comply with the requirements for preparing, delivering, and offering "old" Part II of Form ADV.

Note: Until you are required to meet the requirements of (amended) Part 2, you can satisfy the requirements related to "old" Part II by updating the information in your "old" Part II whenever it becomes materially inaccurate. You must deliver "old" Part II or a brochure containing at least the information contained in "old" Part II to prospective *clients* and annually offer it to current *clients*. You are not required to file "old" Part II with the SEC, but you must keep a copy in your files, and provide it to the SEC staff upon request.

If you are applying for registration or are registered with one or more *state securities authorities*, contact the appropriate *state securities authorities* or check <http://www.nasaa.org> for more information about the implementation deadline for the amended Part 2.

6. Where do I sign my Form ADV application or amendment?

You must sign the appropriate Execution Page. There are three Execution Pages at the end of the form. Your initial application and all amendments to Form ADV must include at least one Execution Page.

- If you are applying for or are amending your SEC registration, you must sign and submit either a:
    - Domestic Investment Adviser Execution Page, if you (the advisory firm) are a resident of the United States; or
    - *Non-Resident* Investment Adviser Execution Page, if you (the advisory firm) are not a resident of the United States.

- If you are applying for or are amending your registration with a *state securities authority*, you must sign and submit the State-Registered Investment Adviser Execution Page.

7. Who must sign my Form ADV or amendment?

The individual who signs the form depends upon your form of organization:

- For a sole proprietorship, the sole proprietor.
- For a partnership, a general partner.
- For a corporation, an authorized principal officer.
- For a "separately identifiable department or division" (SID) of a bank, a principal officer of your bank who is directly engaged in the management, direction, or supervision of your investment advisory activities.
- For all others, an authorized individual who participates in managing or directing your affairs.

The signature does not have to be notarized, and in the case of an electronic filing, should be a typed name.

8. How do I file my Form ADV?

Complete Form ADV electronically using the Investment Adviser Registration Depository (IARD) if:

- You are filing with the SEC (and submitting *notice filings* to any of the *state securities authorities*), or

- You are filing with a *state securities authority* that requires or permits advisers to submit Form ADV through the IARD.

  Note: SEC rules require advisers that are registered or applying for registration with the SEC to file electronically through the IARD system. See SEC rule 203-1. Check with the *state securities authorities* of each state in which you have a filing obligation to determine whether you can or must file Form ADV electronically through the IARD.

To file electronically, go to the IARD website (<www.iard.com>), which contains detailed instructions for advisers to follow when filing through the IARD.

Complete Form ADV (Paper Version) on paper if:

- You are filing with the SEC or a *state securities authority* that requires electronic filing, but you have been granted a continuing hardship exemption. Hardship exemptions are described in Instruction 14.

- You are filing with a *state securities authority* that permits (but does not require) electronic filing and you do not file electronically.

9. How do I get started filing electronically?

- First, get a copy of the IARD Entitlement Package from the following web site: <http://www.iard.com/GetStarted.asp>. Second, request access to the IARD system for your firm by completing and submitting the IARD Entitlement Package. The IARD Entitlement Package must be submitted on paper. Mail the forms to: FINRA Entitlement Group, P.O. Box 9495, Gaithersburg, MD 20898-9495.

- When FINRA receives your Entitlement Package, they will assign a *CRD* number (identification number for your firm) and a user I.D. code and password (identification number and system password for the individual(s) who will submit Form ADV filings for your firm). Your firm may request an I.D. code and password for more than one individual. FINRA also will create a financial account for you from which the IARD will deduct filing fees and any state fees you are required to pay. If you already have a *CRD* account with FINRA, it will also serve as your IARD account; a separate account will not be established.

- Once you receive your *CRD* number, user I.D. code and password, and you have funded your account, you are ready to file electronically.

- Questions regarding the Entitlement Process should be addressed to FINRA at 240.386.4848.

10. If I am applying for registration with the SEC, or amending my SEC registration, how do I make *notice filings* with the *state securities authorities*?

If you are applying for registration with the SEC or are amending your SEC registration, one or more *state securities authorities* may require you to provide them with copies of your SEC filings. We call these filings "*notice filings*." Your *notice filings* will be sent electronically to the states that you check on Item 2.B. of Part 1A. The *state securities authorities* to which you send *notice filings* may charge fees, which will be deducted from the account you establish with FINRA. To determine which *state securities authorities* require SEC-registered advisers to submit *notice filings* and to pay fees, consult the relevant state investment adviser law or *state securities authority*. See General Instruction 1.

If you are granted a continuing hardship exemption to file Form ADV on paper, FINRA will enter your filing into the IARD and your *notice filings* will be sent electronically to the *state securities authorities* that you check on Item 2.B. of Part 1A.

11. I am registered with a state. When must I switch to SEC registration?

If you report on your *annual updating amendment* that your assets under management have increased to $30 million or more, you must register with the SEC within 90 days after you file that *annual updating amendment*. If your assets under management increase to $25 million or more but not $30 million, you may, but are not required to, register with the SEC (assuming you are not otherwise required to register with the SEC). Once you register with the SEC, you are subject to SEC regulation, regardless of whether you remain registered with one or more states. Each of your

investment adviser representatives, however, may be subject to registration in those states in which the representative has a place of business. See SEC rule 203A-1(b). For additional information, consult the investment adviser laws or the *state securities authority* for the particular state in which you are "doing business." See General Instruction 1.

Note: The amount of assets under management that determines whether you register with the SEC or states will change in 2011 as a result of amendments to the Investment Advisers Act.

12. I am registered with the SEC. When must I switch to registration with a *state securities authority*?

If you report on your *annual updating amendment* that you have assets under management of less than $25 million and you are not otherwise eligible to register with the SEC, you must withdraw from SEC registration within 180 days after the end of your fiscal year by filing Form ADV-W. You should consult state law in the states that you are doing business to determine if you are required to register in these states. See General Instruction 1. Until you file your Form ADV-W with the SEC, you will remain subject to SEC regulation, and you also will be subject to regulation in any states where you register. See SEC rule 203A-1(b).

Note: The amount of assets under management that determines whether you register with the SEC or states will change in 2011 as a result of amendments to the Investment Advisers Act.

13. Are there filing fees?

Yes. These fees go to support and maintain the IARD. The IARD filing fees are in addition to any registration or other fee that may be required by state law. You must pay an IARD filing fee for your initial application and each *annual updating amendment*. There is no filing fee for an other-than-annual amendment or Form ADV-W. The IARD filing fee schedule is published at <http://www.sec.gov/iard>; <http://www.nasaa.org>; and <http://www.iard.com>.

If you are submitting a paper filing under a continuing hardship exemption (see Instruction 14), you are required to pay an additional fee. The amount of the additional fee depends on whether you are filing Form ADV or Form ADV-W. (There is no additional fee for filings made on Form ADV-W.) The hardship filing fee schedule is available by contacting FINRA at 240.386.4848.

14. What if I am not able to file electronically?

If you are required to file electronically but cannot do so, you may be eligible for one of two types of hardship exemptions from the electronic filing requirements.

- A **temporary hardship exemption** is available if you file electronically, but you encounter unexpected difficulties that prevent you from making a timely filing with the IARD, such as a computer malfunction or electrical outage. This exemption does not permit you to file on paper; instead, it extends the deadline for an electronic filing for seven business days. See SEC rule 203-3(a).

- A **continuing hardship exemption** may be granted if you are a small business and you can demonstrate that filing electronically would impose an undue hardship. You are a small business, and may be eligible for a continuing hardship exemption, if you are required to answer Item 12 of Part 1A (because you have assets under management of less than $25 million) and you are able to respond "no" to each question in Item 12. See SEC rule 0-7.

  If you have been granted a continuing hardship exemption, you must complete and submit the paper version of Form ADV to FINRA. FINRA will enter your responses into the IARD. As discussed in General Instruction 13, FINRA will charge you a fee to reimburse it for the expense of data entry.

  Before applying for a continuing hardship exemption, consider engaging a firm that assists investment advisers in making filings with the IARD. Check the SEC's web site (<http://www.sec.gov/iard>) to obtain a list of firms that provide these services.

15. I am eligible to file on paper. How do I make a paper filing?

When filing on paper, you must:

- Type all of your responses.
- Include your name (the same name you provide in response to Item 1.A. of Part 1A) and the date on every page.
- If you are amending your Form ADV:
  - complete page 1 and circle the number of any item for which you are changing your response.
  - include your SEC 801-number (if you have one) and your *CRD* number (if you have one) on every page.
  - complete the amended item in full and circle the number of the item for which you are changing your response.
  - to amend Schedule A or Schedule B, complete and submit Schedule C.

Where you submit your paper filing depends on why you are eligible to file on paper:

- If you are filing on paper because you have been granted a continuing hardship exemption, submit one manually signed Form ADV and one copy to: IARD Document Processing, FINRA, P.O. Box 9495, Gaithersburg, MD 20898-9495.

  If you complete Form ADV on paper and submit it to FINRA but you do not have a continuing hardship exemption, the submission will be returned to you.

- If you are filing on paper because a state in which you are registered or in which you are applying for registration allows you to submit paper instead of electronic filings, submit one manually signed Form ADV and one copy to the appropriate *state securities authorities*.

16. Who is required to file Form ADV-NR?

Every *non-resident* general partner and *managing agent* of all SEC-registered advisers, whether or not the adviser is resident in the United States, must file Form ADV-NR in connection with the adviser's initial application. A general partner or *managing agent* of an SEC-registered adviser who becomes a *non-resident* after the adviser's initial application has been submitted must file Form ADV-NR within 30 days. Form ADV-NR must be filed on paper (it cannot be filed electronically).

Submit Form ADV-NR to the SEC at the following address:

> Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549; Attn: Branch of Registrations and Examinations.

Failure to file Form ADV-NR promptly may delay SEC consideration of your initial application.

Federal Information Law and Requirements

Sections 203(c) and 204 of the Advisers Act [15 U.S.C. §§ 80b-3(c) and 80b-4] authorize the SEC to collect the information required by Form ADV. The SEC collects the information for regulatory purposes, such as deciding whether to grant registration. Filing Form ADV is mandatory for advisers who are required to register with the SEC. The SEC maintains the information submitted on this form and makes it publicly available. The SEC may return forms that do not include required information. Intentional misstatements or omissions constitute federal criminal violations under 18 U.S.C. § 1001 and 15 U.S.C. § 80b-17.

SEC's Collection of Information

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The Advisers Act authorizes the SEC to collect the information on Form ADV from applicants. See 15 U.S.C. §§ 80b-3(c)(1) and 80b-4. Filing the form is mandatory.

The main purpose of this form is to enable the SEC to register investment advisers. Every applicant for registration with the SEC as an adviser must file the form. See 17 C.F.R. § 275.203-1. By accepting a form, however, the SEC does not make a finding that it has been completed or submitted correctly. The form is filed annually by every adviser, no later than 90 days after the end of its fiscal year, to amend its registration. It is also filed promptly during the year to reflect material changes. See 17 C.F.R. § 275.204-1. The SEC maintains the information on the form and makes it publicly available through the IARD.

Anyone may send the SEC comments on the accuracy of the burden estimate on page 1 of the form, as well as suggestions for reducing the burden. The Office of Management and Budget has reviewed this collection of information under 44 U.S.C. § 3507.

The information contained in the form is part of a system of records subject to the Privacy Act of 1974, as amended. The SEC has published in the Federal Register the Privacy Act System of Records Notice for these records.

Appendix B

GLOSSARY OF TERMS

1. **Advisory Affiliate:** Your advisory affiliates are (1) all of your officers, partners, or directors (or any ***person*** performing similar functions); (2) all ***persons*** directly or indirectly ***controlling*** or ***controlled*** by you; and (3) all of your current ***employees*** (other than ***employees*** performing only clerical, administrative, support or similar functions).

   If you are a "separately identifiable department or division" (SID) of a bank, your ***advisory affiliates*** are: (1) all of your bank's ***employees*** who perform your investment advisory activities (other than clerical or administrative ***employees***); (2) all ***persons*** designated by your bank's board of directors as responsible for the day-to-day conduct of your investment advisory activities (including supervising the ***employees*** who perform investment advisory activities); (3) all ***persons*** who directly or indirectly ***control*** your bank, and all ***persons*** whom you ***control*** in connection with your investment advisory activities; and (4) all other ***persons*** who directly manage any of your investment advisory activities (including directing, supervising or performing your advisory activities), all ***persons*** who directly or indirectly ***control*** those management functions, and all ***persons*** whom you ***control*** in connection with those management functions. *[Used in: Part 1A, Items 7, 11, DRPs; Part 1B, Item 2]*

2. **Annual Updating Amendment:** Within 90 days after your firm's fiscal year end, your firm must file an "annual updating amendment," which is an amendment to your firm's Form ADV that reaffirms the eligibility information contained in Item 2 of Part 1A and updates the responses to any other item for which the information is no longer accurate. *[Used in: General Instructions; Part 1A Instructions, Introductory Text, Item 2; Part 2A, Instructions, Appendix 1 Instructions; Part 2B, Instructions]*

3. **Brochure:** A written disclosure statement that you must provide to ***clients*** and prospective ***clients***. See SEC rule 204-3; Form ADV, Part 2A. *[Used in: General Instructions; Used throughout Part 2]*

4. **Brochure Supplement:** A written disclosure statement containing information about certain of your supervised persons that your firm is required by Part 2B of Form ADV to provide to clients and prospective clients. See SEC rule 204-3; Form ADV, Part 2B. *[Used in: General Instructions; Used throughout Part 2]*

5. **Charged:** Being accused of a crime in a formal complaint, information, or indictment (or equivalent formal charge). *[Used in: Part 1A, Item 11; DRPs]*

6. **Client:** Any of your firm's investment advisory clients. This term includes clients from which your firm receives no compensation, such as members of your family. If your firm also provides other services (e.g., accounting services), this term does not include clients that are not investment advisory clients. *[Used throughout Form ADV and Form ADV-W]*

7. **Control:** Control means the power, directly or indirectly, to direct the management or policies of a ***person***, whether through ownership of securities, by contract, or otherwise.

   - Each of your firm's officers, partners, or directors exercising executive responsibility (or ***persons*** having similar status or functions) is presumed to control your firm.

   - A ***person*** is presumed to control a corporation if the ***person***: (i) directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or (ii) has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities.

   - A ***person*** is presumed to control a partnership if the ***person*** has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership.

   - A ***person*** is presumed to control a limited liability company ("LLC") if the ***person***: (i) directly or indirectly has the right to vote 25 percent or more of a class of the interests of the LLC; (ii) has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the LLC; or (iii) is an elected manager of the LLC.

   - A ***person*** is presumed to control a trust if the ***person*** is a trustee or ***managing agent*** of the trust.

   [Used in: General Instructions; Part 1A, Instructions, Items 2, 7, 10, 11, 12, Schedules A, B, C, D; DRPs]

8. **Custody:** Custody means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:

   - Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;

   - Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and

   - Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of

or access to client funds or securities. *[Used in: Part 1A, Item 9; Part 1B, Instructions, Item 2; Part 2A, Items 15, 18]*

9. **Discretionary Authority or Discretionary Basis:** Your firm has discretionary authority or manages assets on a discretionary basis if it has the authority to decide which securities to purchase and sell for the ***client***. Your firm also has discretionary authority if it has the authority to decide which investment advisers to retain on behalf of the ***client***. *[Used in: Part 1A, Instructions, Item 8; Part 1B, Instructions; Part 2A, Items 4, 16, 18; Part 2B, Instructions]*

10. **Employee:** This term includes an independent contractor who performs advisory functions on your behalf. *[Used in: Part 1A, Instructions, Items 1, 5, 11; Part 2B, Instructions]*

11. **Enjoined:** This term includes being subject to a mandatory injunction, prohibitory injunction, preliminary injunction, or a temporary restraining ***order***. *[Used in: Part 1A, Item 11; DRPs]*

12. **Felony:** For jurisdictions that do not differentiate between a felony and a ***misdemeanor***, a felony is an offense punishable by a sentence of at least one year imprisonment and/or a fine of at least $1,000. The term also includes a general court martial. *[Used in: Part 1A, Item 11; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

13. **FINRA CRD** or **CRD:** The Web Central Registration Depository ("CRD") system operated by FINRA for the registration of broker-dealers and broker-dealer representatives. *[Used in: General Instructions, Part 1A, Item 1, Schedules A, B, C, D, DRPs; Form ADV-W, Item 1]*

14. **Foreign Financial Regulatory Authority:** This term includes (1) a foreign securities authority; (2) another governmental body or foreign equivalent of a ***self-regulatory organization*** empowered by a foreign government to administer or enforce its laws relating to the regulation of ***investment-related*** activities; and (3) a foreign membership organization, a function of which is to regulate the participation of its members in the activities listed above. *[Used in: Part 1A, Items 1, 11; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

15. **Found:** This term includes adverse final actions, including consent decrees in which the respondent has neither admitted nor denied the findings, but does not include agreements, deficiency letters, examination reports, memoranda of understanding, letters of caution, admonishments, and similar informal resolutions of matters. *[Used in: Part 1A, Item 11; Part 1B, Item 2; Part 2A, Item 9; Part 2B, Item 3]*

16. **Government Entity:** Any state or political subdivision of a state, including (i) any agency, authority, or instrumentality of the state or political subdivision; (ii) a plan or pool of assets ***controlled*** by the state or political subdivision or any agency, authority, or instrumentality thereof; and (iii) any officer, agent, or employee of the state or political subdivision or any

agency, authority, or instrumentality thereof, acting in their official capacity. *[Used in: Part 1A, Item 5]*

17. **High Net Worth Individual:** An individual with at least $750,000 managed by you, or whose net worth your firm reasonably believes exceeds $1,500,000, or who is a "qualified purchaser" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940. The net worth of an individual may include assets held jointly with his or her spouse. *[Used in: Part 1A, Item 5]*

18. **Home State:** If your firm is registered with a ***state securities authority***, your firm's "home state" is the state where it maintains its ***principal office and place of business***. *[Used in: Part 1B, Instructions]*

19. **Impersonal Investment Advice:** Investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts. *[Used in: Part 1A, Instructions; Part 2A, Instructions; Part 2B, Instructions]*

20. **Investment Adviser Representative:** Investment adviser representatives of SEC-registered advisers may be required to register in each state in which *they have a* ***place of business.*** *Any of your firm's* ***supervised persons*** *(except* those that provide only ***impersonal investment advice***) is an investment adviser representative, if --

    - the ***supervised person*** regularly solicits, meets with, or otherwise communicates with your firm's ***clients***,
    - the ***supervised person*** has more than five ***clients*** who are natural persons and not ***high net worth individuals***, and
    - more than ten percent of the ***supervised person's*** clients are natural persons and not ***high net worth individuals.***

NOTE: If your firm is registered with the ***state securities authorities*** and not the SEC, your firm may be subject to a different state definition of "investment adviser representative."

[Used in: General Instructions; Part 1A, Item 7; Part 2B, Item 1]

21. **Investment-Related:** Activities that pertain to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with an investment adviser, broker-dealer, municipal securities dealer, government securities broker or dealer, issuer, investment company, futures sponsor, bank, or savings association). *[Used in: Part 1A, Items, 7, 11, DRPs; Part 1B, Item 2; Part 2A, Items 9 and 19; Part 2B, Items 3, 4 and 7]*

22. **Involved:** Engaging in any act or omission, aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act. *[Used in: Part 1A, Item 11; Part 2A, Items 9 and 19; Part 2B, Items 3 and 7]*

23. **Management Persons:** Anyone with the power to exercise, directly or indirectly, a ***controlling*** influence over your firm's management or policies, or to determine the general investment advice given to the ***clients*** of your firm.

    Generally, all of the following are management persons:

    - Your firm's principal executive officers, such as your chief executive officer, chief financial officer, chief operations officer, chief legal officer, and chief compliance officer; your directors, general partners, or trustees; and other individuals with similar status or performing similar functions;

    - The members of your firm's investment committee or group that determines general investment advice to be given to ***clients***; and

    - If your firm does not have an investment committee or group, the individuals who determine general investment advice provided to ***clients*** (if there are more than five people, you may limit your firm's response to their supervisors).

    [Used in: Part 1B, Item 2; Part 2A, Items 9, 10 and 19]

24. **Managing Agent:** A managing agent of an investment adviser is any ***person***, including a trustee, who directs or manages (or who participates in directing or managing) the affairs of any unincorporated organization or association that is not a partnership. *[Used in: General Instructions; Form ADV-NR; Form ADV-W, Item 8]*

25. **Minor Rule Violation:** A violation of a ***self-regulatory organization*** rule that has been designated as "minor" pursuant to a plan approved by the SEC. A rule violation may be designated as "minor" under a plan if the sanction imposed consists of a fine of $2,500 or less, and if the sanctioned ***person*** does not contest the fine. (Check with the appropriate ***self-regulatory organization*** to determine if a particular rule violation has been designated as "minor" for these purposes.) *[Used in: Part 1A, Item 11]*

26. **Misdemeanor:** For jurisdictions that do not differentiate between a ***felony*** and a misdemeanor, a misdemeanor is an offense punishable by a sentence of less than one year imprisonment and/or a fine of less than $1,000. The term also includes a special court martial. *[Used in: Part 1A, Item 11; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

27. **Non-Resident:** (a) an individual who resides in any place not subject to the jurisdiction of the United States; (b) a corporation incorporated in or having its ***principal office and place of business*** in any place not subject to the jurisdiction of the United States; and (c) a partnership or other unincorporated organization or association that has its ***principal office and place of business*** in any place not subject to the jurisdiction of the United States. *[Used in: General Instructions; Form ADV-NR]*

28. **Notice Filing:** SEC-registered advisers may have to provide ***state securities authorities*** with copies of documents that are filed with the SEC. These filings are referred to as "notice filings." *[Used in: General Instructions; Part 1A, Item 2; Execution Page(s); Form ADV-W]*

29. **Order:** A written directive issued pursuant to statutory authority and procedures, including an order of denial, exemption, suspension, or revocation. Unless included in an order, this term does not include special stipulations, undertakings, or agreements relating to payments, limitations on activity or other restrictions. *[Used in: Part 1A, Items 2 and 11; Schedule D; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

30. **Performance-Based Fee:** An investment advisory fee based on a share of capital gains on, or capital appreciation of, ***client*** assets. A fee that is based upon a percentage of assets that you manage is not a performance-based fee. *[Used in: Part 1A, Item 5; Part 2A, Items 6 and 19]*

31. **Person:** A natural person (an individual) or a company. A company includes any partnership, corporation, trust, limited liability company ("LLC"), limited liability partnership ("LLP"), sole proprietorship, or other organization. *[Used throughout Form ADV and Form ADV-W]*

32. **Principal Place of Business** or **Principal Office and Place of Business:** Your firm's executive office from which your firm's officers, partners, or managers direct, ***control***, and coordinate the activities of your firm. *[Used in: Part 1A, Instructions, Items 1 and 2; Schedule D; Form ADV-W, Item 1]*

33. **Proceeding:** This term includes a formal administrative or civil action initiated by a governmental agency, ***self-regulatory organization*** or ***foreign financial regulatory authority***; a ***felony*** criminal indictment or information (or equivalent formal charge); or a ***misdemeanor*** criminal information (or equivalent formal charge). This term does not include other civil litigation, investigations, or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge). *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2; Part 2A, Item 9; Part 2B, Item 3]*

34. **Related Person:** Any ***advisory affiliate*** and any ***person*** that is under common ***control*** with your firm. *[Used in: Part 1A, Items 7, 8, 9; Schedule D; Form ADV-W, Item 3; Part 2A, Items 10, 11, 12, 14; Part 2A, Appendix 1, Item 6]*

35. **Self-Regulatory Organization** or **SRO:** Any national securities or commodities exchange, registered securities association, or registered clearing agency. For example, the Chicago Board of Trade ("CBOT"), FINRA and New York Stock Exchange ("NYSE") are self-regulatory organizations. *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2; Part 2A, Items 9 and 19; Part 2B, Items 3 and 7]*

36. **Sponsor:** A sponsor of a ***wrap fee program*** sponsors, organizes, or administers the program or selects, or provides advice to ***clients*** regarding the selection of, other investment advisers in the program. *[Used in: Part 1A, Item 5; Schedule D; Part 2A, Instructions, Appendix 1 Instructions]*

37. **State Securities Authority:** The securities commission (or any agency or office performing like functions) of any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. *[Used throughout Form ADV]*

38. **Supervised Person:** Any of your officers, partners, directors (or other ***persons*** occupying a similar status or performing similar functions), or ***employees***, or any other ***person*** who provides investment advice on your behalf and is subject to your supervision or ***control***. *[Used throughout Part 2]*

39. **Wrap Brochure** or **Wrap Fee Program Brochure:** The written disclosure statement that ***sponsors*** of ***wrap fee programs*** must provide to each of their ***wrap fee program clients***. *[Used in: Part 2, General Instructions; Used throughout Part 2A, Appendix 1]*

40. **Wrap Fee Program:** Any advisory program under which a specified fee or fees not based directly upon transactions in a ***client's*** account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of ***client*** transactions. *[Used in: Part 1, Item 5; Schedule D; Part 2A, Instructions, Item 4, used throughout Appendix 1; Part 2B, Instructions]*

Appendix C

FORM ADV (Paper Version)

UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

PART 2: Uniform Requirements for the Investment Adviser *Brochure* and *Brochure Supplements*

General Instructions for Part 2 of Form ADV

Under SEC and similar state rules you are required to deliver to *clients* and prospective *clients* a *brochure* disclosing information about your firm. You also may be required to deliver a *brochure supplement* disclosing information about one or more of your *supervised persons*. Part 2 of Form ADV sets out the minimum required disclosure that your *brochure* (Part 2A for a firm *brochure*, or Appendix 1 for a *wrap fee program brochure*) and *brochure supplements* (Part 2B) must contain.

Read all the instructions, including General Instructions for Form ADV, General Instructions for Part 2 of Form ADV, Instructions for Part 2A of Form ADV, Instructions for Part 2B of Form ADV, and (if you are preparing or updating a *wrap fee program brochure*) Instructions for Part 2A Appendix 1 of Form ADV, before preparing or updating your *brochure* or *brochure supplements*.

1. Narrative Format. Part 2 of Form ADV consists of a series of items that contain disclosure requirements for your firm's *brochure* and any required supplements. The items require narrative responses. You must respond to each item in Part 2. You must include the heading for each item provided by Part 2 immediately preceding your response to that item and provide responses in the same order as the items appear in Part 2. If an item does not apply to your business, you must indicate that item is not applicable. If you have provided information in response to one item that is also responsive to another item, you may cross-reference that information in response to the other item.

2. Plain English. The items in Part 2 of Form ADV are designed to promote effective communication between you and your *clients*. Write your *brochure* and supplements in plain English, taking into consideration your *clients*' level of financial sophistication. Your *brochure* should be concise and direct. In drafting your *brochure* and *brochure supplements*, you should: (i) use short sentences; (ii) use definite, concrete, everyday words; (iii) use active voice; (iv) use tables or bullet lists for complex material, whenever possible; (v) avoid legal jargon or highly technical business terms unless you explain them or you believe that your *clients* will understand them; and (vi) avoid multiple negatives. Consider providing examples to illustrate a description of your practices or policies. The brochure should discuss only conflicts the adviser has or is reasonably likely to have, and practices in which it engages or is reasonably likely to engage. If a conflict arises or the adviser decides to engage in a practice that it has not disclosed, supplemental disclosure must be provided to clients to obtain their consent. If you have a conflict or engage in a practice with respect to some (but not all) types or classes of clients, advice, or transactions, indicate as such rather than disclosing that you "may" have the conflict or engage in the practice.

   Note: The SEC's Office of Investor Education and Advocacy has published A Plain English Handbook. You may find the handbook helpful in writing your *brochure* and supplements. For a copy of this handbook, visit the SEC's web site at<www.sec.gov/news/extra/handbook.htm> or call 1-800-732-0330.

3. Disclosure Obligations as a Fiduciary. Under federal and state law, you are a fiduciary and must make full disclosure to your *clients* of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your *clients* that could affect the advisory relationship. This obligation

requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to *clients* information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require. You may disclose this additional information to *clients* in your *brochure* or by some other means.

4. <u>Full and Truthful Disclosure</u>. All information in your *brochure* and *brochure supplements* must be true and may not omit any material facts.

5. <u>Filing</u>. You must file your *brochure(s)* (and amendments) through the IARD system using the text-searchable Adobe Portable Document Format ("PDF"). See SEC rules 203-1 and 204-1 and similar state rules. If you are registered or are registering with the SEC, you are not required to file your *brochure supplements* through the IARD or otherwise. You must, however, preserve a copy of the supplements and make them available to SEC staff upon request. See SEC rule 204-2(a)(14). If you are registered or are registering with one or more *state securities authorities*, you must file a copy of the *brochure supplement* for each *supervised person* doing business in that state.

Instructions for Part 2A of Form ADV: Preparing Your Firm *Brochure*

1. To whom must we deliver a firm *brochure*? You must give a firm *brochure* to each *client*. You must deliver the *brochure* even if your advisory agreement with the *client* is oral. See SEC rule 204-3(b) and similar state rules.

   If you are registered with the SEC, you are not required to deliver your *brochure* to either (i) *clients* who receive only *impersonal investment advice* from you and who will pay you less than $500 per year or (ii) *clients* that are SEC-registered investment companies or business development companies (the *client* must be registered under the Investment Company Act of 1940 or be a business development company as defined in that Act, and the advisory contract must meet the requirements of section 15(c) of that Act). See SEC rule 204-3(c).

   Note: Even if you are not required to give a *brochure* to a *client*, as a fiduciary you may still be required to provide your *clients* with similar information, particularly material information about your conflicts of interest and about your disciplinary information. If you are not required to give a *client* a *brochure*, you may make any required disclosures to that *client* by delivery of your *brochure* or through some other means.

2. When must we deliver a *brochure* to *clients*?

   - You must give a firm *brochure* to each *client* before or at the time you enter into an advisory agreement with that *client*. See SEC rule 204-3(b) and similar state rules.

   - Each year you must (i) deliver, within 120 days of the end of your fiscal year, to each *client* a free updated *brochure* that either includes a summary of material changes or is accompanied by a summary of material changes, or (ii) deliver to each *client* a summary of material changes that includes an offer to provide a copy of the updated *brochure* and information on how a *client* may obtain the *brochure*. See SEC rule 204-3(b) and similar state rules.

   - You do not have to deliver an interim amendment to *clients* unless the amendment includes information in response to Item 9 of Part 2A (disciplinary information). An interim amendment can be in the form of a document describing the material facts relating to the amended disciplinary event. See SEC rule 204-3(b) and similar state rules.

   Note: As a fiduciary, you have an ongoing obligation to inform your *clients* of any material information that could affect the advisory relationship. As a result, between *annual updating amendments* you must disclose material changes to such information to *clients* even if those changes do not trigger delivery of an interim amendment. See General Instructions for Part 2 of Form ADV, Instruction 3.

3. May we deliver our *brochure* electronically? Yes. The SEC has published interpretive guidance on delivering documents electronically, which you can find at <www.sec.gov/rules/concept/33-7288.txt>.

4. When must we update our *brochure*? You must update your *brochure*: (i) each year at the time you file your *annual updating amendment*; and (ii) promptly whenever any information in the *brochure* becomes materially inaccurate. You are not required to update your *brochure* between annual amendments solely because the amount of *client* assets you manage has changed or because your fee schedule has changed. However, if you are updating your *brochure* for a separate reason in between annual amendments, and the amount of *client* assets you manage listed in response to Item 4.E or your fee schedule listed in response to Item 5.A has become materially inaccurate, you should update that item(s) as part of the interim amendment. All updates to your *brochure* must be filed through the IARD system and maintained in your files. See SEC rules 204-1 and 204-2(a)(14) and similar state rules.

5. We are filing our *annual updating amendment*. The last *brochure*(s) that we filed does not contain any materially inaccurate information. Do we have to prepare a summary of material changes? No, as long as you

have not filed any interim amendments making material changes to the *brochure* that you filed with last year's *annual updating amendment*. If you do not have to prepare a summary of material changes, you do not have to deliver a summary of material changes or a *brochure* to your existing *clients* that year. See SEC rule 204-3(b). If you are a state-registered adviser, you should contact the appropriate *state securities authorities* to determine whether you must make an annual offer of the brochure.

6. Do we need to include the summary of material changes that we prepare in response to Item 2 with *our annual updating amendment* filing on IARD? Yes, you need to include the summary in your *annual updating amendment*. Item 2 permits you to include the summary as part of the *brochure* (on the cover page or the page immediately following the cover page) or to create a separate document containing the summary. If you include the summary as part of your *brochure,* the summary will be part of the *annual updating amendment* filing that you submit on IARD. If your summary of material changes is a separate document, you must attach the summary as an exhibit to your *brochure* and upload your *brochure* and the summary together in a single, text-searchable file in Adobe Portable Document Format on IARD for your *annual updating amendment*.

   Note: If you include the summary of material changes in your *brochure*, and you revise or update your *brochure* between *annual updating amendments*, you should consider whether you should update the summary as part of that other-than annual amendment to avoid confusing or misleading *clients* reading the updated *brochure*.

7. We have determined that we have no *clients* to whom we must deliver a *brochure*. Must we prepare one? No, but see note to Instruction 1 above.

8. May we include a summary of the *brochure* at the beginning of our *brochure*? Yes. Although it is not required, you may choose to include a summary of the *brochure* at the beginning of your *brochure*. Such summary, however, may not substitute for the summary of material changes required by Item 2 of Part 2A.

9. We offer several advisory services. May we prepare multiple firm *brochures*? Yes. If you offer substantially different types of advisory services, you may opt to prepare separate *brochures* so long as each *client* receives all applicable information about services and fees. Each *brochure* may omit information that does not apply to the advisory services and fees it describes. For example, your firm *brochure* sent to your *clients* who invest only in the United States can omit information about your advisory services and fees relating to offshore investments. See SEC rule 204-3(e) and similar state rules. If you prepare separate *brochures* you must file each *brochure* (and any amendments) through the IARD system as required in SEC rules 203-1 and 204-1 and similar state rules.

10. We *sponsor* a *wrap fee program*. Is there a different *brochure* that we need to deliver to our wrap fee *clients*? Yes. If you *sponsor* a *wrap fee program*, you must deliver a *wrap fee program brochure* to your wrap fee *clients*. The disclosure requirements for preparing a *wrap fee program brochure* appear in Part 2A, Appendix 1 of Form ADV. If your entire advisory business is *sponsoring wrap fee programs*, you do not need to prepare a firm *brochure* separate from your *wrap fee program brochure(s)*. See SEC rule 204-3(d) and similar state rules.

11. We provide portfolio management services to *clients* in *wrap fee programs* that we do not *sponsor*. Which *brochure* must we deliver to these *clients*? You must deliver your *brochure* prepared in accordance with Part 2A (not Appendix 1) to your wrap fee *clients*. You also must deliver to these *clients* any *brochure supplements* required by Part 2B of Form ADV.

12. May we include information not required by an item in our *brochure*? Yes. If you include information not required by an item, however, you may not include so much additional information that the required information is obscured.

13. Item 18 requires us to give our *clients* an audited balance sheet. May any public accountant perform the audit? Your auditor must be independent. Article 2 of SEC Regulation S-X sets out the general rules for auditor

independence. Please note that these requirements may be different from the rules of professional organizations.

14. We are a new firm. Do we need a *brochure*? Yes. Respond to items in Part 2A of Form ADV based on the advisory services you propose to provide and the practices, policies and procedures you propose to adopt.

15. We are a "separately identifiable department or division" (SID) of a bank. Must our *brochure* discuss our bank's general business practices? No. Information you include in your firm *brochure* (or in *brochure supplements*) should be information about you, the SID, and your business practices, rather than general information about your bank.

Part 2A of Form ADV: Firm *Brochure*

Item 1 Cover Page

A. The cover page of your *brochure* must state your name, business address, contact information, website address (if you have one), and the date of the *brochure*.

Note: If you primarily conduct advisory business under a name different from your full legal name, and you have disclosed your business name in Item 1.B of Part 1A of Form ADV, then you may use your business name throughout your *brochure*.

B. Display on the cover page of your *brochure* the following statement or other clear and concise language conveying the same information, and identifying the document as a "brochure":

This brochure provides information about the qualifications and business practices of [your name]. If you have any questions about the contents of this brochure, please contact us at [telephone number and/or email address]. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Additional information about [your name] also is available on the SEC's website at www.adviserinfo.sec.gov.

C. If you refer to yourself as a "registered investment adviser" or describe yourself as being "registered," include a statement that registration does not imply a certain level of skill or training.

Item 2 Material Changes

If you are amending your *brochure* for your annual update and it contains material changes from your last annual update, identify and discuss those changes on the cover page of the *brochure* or on the page immediately following the cover page, or as a separate document accompanying the *brochure*. You must state clearly that you are discussing only material changes since the last annual update of your *brochure*, and you must provide the date of the last annual update of your *brochure*.

Note: You do not have to separately provide this information to a *client* or prospective *client* who has not received a previous version of your *brochure*.

Item 3 Table of Contents

Provide a table of contents to your *brochure*.

Note: Your table of contents must be detailed enough so that your *clients* can locate topics easily. Your *brochure* must follow the same order, and contain the same headings, as the items listed in Part 2A.

Item 4 Advisory Business

A. Describe your advisory firm, including how long you have been in business. Identify your principal owner(s).

Notes: (1) For purposes of this item, your principal owners include the *persons* you list as owning 25% or more of your firm on Schedule A of Part 1A of Form ADV (Ownership Codes C, D or E). (2) If you are a publicly held company without a 25% shareholder, simply disclose that you are publicly held. (3) If an individual or company owns 25% or more of your firm through subsidiaries, you must identify the individual or parent company and intermediate subsidiaries. If you are an SEC-registered adviser, you

must identify intermediate subsidiaries that are publicly held, but not other intermediate subsidiaries. If you are a state-registered adviser, you must identify all intermediate subsidiaries.

B. Describe the types of advisory services you offer. If you hold yourself out as specializing in a particular type of advisory service, such as financial planning, quantitative analysis, or market timing, explain the nature of that service in greater detail. If you provide investment advice only with respect to limited types of investments, explain the type of investment advice you offer, and disclose that your advice is limited to those types of investments.

C. Explain whether (and, if so, how) you tailor your advisory services to the individual needs of *clients*. Explain whether *clients* may impose restrictions on investing in certain securities or types of securities.

D. If you participate in *wrap fee programs* by providing portfolio management services, (1) describe the differences, if any, between how you manage wrap fee accounts and how you manage other accounts, and (2) explain that you receive a portion of the wrap fee for your services.

E. If you manage *client* assets, disclose the amount of *client* assets you manage on a *discretionary basis* and the amount of *client* assets you manage on a non-*discretionary basis*. Disclose the date "as of" which you calculated the amounts.

Note: Your method for computing the amount of "*client* assets you manage" can be different from the method for computing "assets under management" required for Item 5.F in Part 1A. However, if you choose to use a different method to compute "*client* assets you manage," you must keep documentation describing the method you use. The amount you disclose may be rounded to the nearest $100,000. Your "as of" date must not be more than 90 days before the date you last updated your *brochure* in response to this Item 4.E.

Item 5 Fees and Compensation

A. Describe how you are compensated for your advisory services. Provide your fee schedule. Disclose whether the fees are negotiable.

Note: If you are an SEC-registered adviser, you do not need to include this information in a *brochure* that is delivered only to qualified purchasers as defined in section 2(a)(51)(A) of the Investment Company Act of 1940.

B. Describe whether you deduct fees from *clients*' assets or bill *clients* for fees incurred. If *clients* may select either method, disclose this fact. Explain how often you bill *clients* or deduct your fees.

C. Describe any other types of fees or expenses *clients* may pay in connection with your advisory services, such as custodian fees or mutual fund expenses. Disclose that *clients* will incur brokerage and other transaction costs, and direct *clients* to the section(s) of your *brochure* that discuss brokerage.

D. If your *clients* either may or must pay your fees in advance, disclose this fact. Explain how a *client* may obtain a refund of a pre-paid fee if the advisory contract is terminated before the end of the billing period. Explain how you will determine the amount of the refund.

E. If you or any of your *supervised persons* accepts compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds, disclose this fact and respond to Items 5.E.1, 5.E.2, 5.E.3 and 5.E.4.

1. Explain that this practice presents a conflict of interest and gives you or your *supervised persons* an incentive to recommend investment products based on the compensation received, rather than on a *client's* needs. Describe generally how you address conflicts that arise, including your procedures for

disclosing the conflicts to *clients*. If you primarily recommend mutual funds, disclose whether you will recommend "no-load" funds.

2. Explain that *clients* have the option to purchase investment products that you recommend through other brokers or agents that are not affiliated with you.

3. If more than 50% of your revenue from advisory *clients* results from commissions and other compensation for the sale of investment products you recommend to your *clients*, including asset-based distribution fees from the sale of mutual funds, disclose that commissions provide your primary or, if applicable, your exclusive compensation.

4. If you charge advisory fees in addition to commissions or markups, disclose whether you reduce your advisory fees to offset the commissions or markups.

Note: If you receive compensation in connection with the purchase or sale of securities, you should carefully consider the applicability of the broker-dealer registration requirements of the Securities Exchange Act of 1934 and any applicable state securities statutes.

Item 6 *Performance-Based Fees* and Side-By-Side Management

If you or any of your *supervised persons* accepts *performance-based fees* – that is, fees based on a share of capital gains on or capital appreciation of the assets of a *client* (such as a *client* that is a hedge fund or other pooled investment vehicle) – disclose this fact. If you or any of your *supervised persons* manage both accounts that are charged a *performance-based fee* and accounts that are charged another type of fee, such as an hourly or flat fee or an asset-based fee, disclose this fact. Explain the conflicts of interest that you or your *supervised persons* face by managing these accounts at the same time, including that you or your *supervised persons* have an incentive to favor accounts for which you or your *supervised persons* receive a *performance-based fee*, and describe generally how you address these conflicts.

Item 7 Types of *Clients*

Describe the types of *clients* to whom you generally provide investment advice, such as individuals, trusts, investment companies, or pension plans. If you have any requirements for opening or maintaining an account, such as a minimum account size, disclose the requirements.

Item 8 Methods of Analysis, Investment Strategies and Risk of Loss

A. Describe the methods of analysis and investment strategies you use in formulating investment advice or managing assets. Explain that investing in securities involves risk of loss that *clients* should be prepared to bear.

B. For each significant investment strategy or method of analysis you use, explain the material risks involved. If the method of analysis or strategy involves significant or unusual risks, discuss these risks in detail. If your primary strategy involves frequent trading of securities, explain how frequent trading can affect investment performance, particularly through increased brokerage and other transaction costs and taxes.

C. If you recommend primarily a particular type of security, explain the material risks involved. If the type of security involves significant or unusual risks, discuss these risks in detail.

Item 9 Disciplinary Information

If there are legal or disciplinary events that are material to a *client's* or prospective *client's* evaluation of your advisory business or the integrity of your management, disclose all material facts regarding those events.

Items 9.A, 9.B, and 9.C list specific legal and disciplinary events presumed to be material for this Item. If your advisory firm or a *management person* has been *involved* in one of these events, you must disclose it under this Item for ten years following the date of the event, unless (1) the event was resolved in your or the *management person's* favor, or was reversed, suspended or vacated, or (2) you have rebutted the presumption of materiality to determine that the event is not material (see Note below). For purposes of calculating this ten-year period, the "date" of an event is the date that the final *order*, judgment, or decree was entered, or the date that any rights of appeal from preliminary *orders*, judgments or decrees lapsed.

Items 9.A, 9.B, and 9.C do not contain an exclusive list of material disciplinary events. If your advisory firm or a *management person* has been *involved* in a legal or disciplinary event that is <u>not</u> listed in Items 9.A, 9.B, or 9.C, but nonetheless is material to a *client's* or prospective *client's* evaluation of your advisory business or the integrity of its management, you must disclose the event. Similarly, even if more than ten years have passed since the date of the event, you must disclose the event if it is so serious that it remains material to a *client's* or prospective *client's* evaluation.

A. A criminal or civil action in a domestic, foreign or military court of competent jurisdiction in which your firm or a *management person*

   1. was convicted of, or pled guilty or nolo contendere ("no contest") to (a) any *felony*; (b) a *misdemeanor* that *involved* investments or an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, or extortion; or (c) a conspiracy to commit any of these offenses;

   2. is the named subject of a pending criminal *proceeding* that involves an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses;

   3. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation; or

   4. was the subject of any *order*, judgment, or decree permanently or temporarily enjoining, or otherwise limiting, your firm or a *management person* from engaging in any *investment-related* activity, or from violating any *investment-related* statute, rule, or *order*.

B. An administrative *proceeding* before the SEC, any other federal regulatory agency, any state regulatory agency, or any *foreign financial regulatory authority* in which your firm or a *management person*

   1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

   2. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation and was the subject of an *order* by the agency or authority

      (a) denying, suspending, or revoking the authorization of your firm or a *management person* to act in an *investment-related* business;

      (b) barring or suspending your firm's or a *management person's* association with an *investment-related* business;

      (c) otherwise significantly limiting your firm's or a *management person's investment-related* activities; or

[illegible]

(d) imposing a civil money penalty of more than $2,500 on your firm or a *management person.*

C. A *self-regulatory organization* (*SRO*) *proceeding* in which your firm or a *management person*

1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

2. was *found* to have been *involved* in a violation of the *SRO's* rules and was: (i) barred or suspended from membership or from association with other members, or was expelled from membership; (ii) otherwise significantly limited from *investment-related* activities; or (iii) fined more than $2,500.

Note: You may, under certain circumstances, rebut the presumption that a disciplinary event is material. If an event is immaterial, you are not required to disclose it. When you review a legal or disciplinary event involving your firm or a *management person* to determine whether it is appropriate to rebut the presumption of materiality, you should consider all of the following factors: (1) the proximity of the *person involved* in the disciplinary event to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time elapsed since the date of the disciplinary event. If you conclude that the materiality presumption has been overcome, you must prepare and maintain a file memorandum of your determination in your records. See SEC rule 204-2(a)(14)(iii).

Item 10 Other Financial Industry Activities and Affiliations

A. If you or any of your *management persons* are registered, or have an application pending to register, as a broker-dealer or a registered representative of a broker-dealer, disclose this fact.

B. If you or any of your *management persons* are registered, or have an application pending to register, as a futures commission merchant, commodity pool operator, a commodity trading advisor, or an associated person of the foregoing entities, disclose this fact.

C. Describe any relationship or arrangement that is material to your advisory business or to your *clients* that you or any of your *management persons* have with any *related person* listed below. Identify the *related person* and if the relationship or arrangement creates a material conflict of interest with *clients*, describe the nature of the conflict and how you address it.

1. broker-dealer, municipal securities dealer, or government securities dealer or broker
2. investment company or other pooled investment vehicle (including a mutual fund, closed-end investment company, unit investment trust, private investment company or "hedge fund," and offshore fund)
3. other investment adviser or financial planner
4. futures commission merchant, commodity pool operator, or commodity trading advisor
5. banking or thrift institution
6. accountant or accounting firm
7. lawyer or law firm
8. insurance company or agency
9. pension consultant
10. real estate broker or dealer
11. sponsor or syndicator of limited partnerships.

D. If you recommend or select other investment advisers for your *clients* and you receive compensation directly or indirectly from those advisers that creates a material conflict of interest, or if you have other business relationships with those advisers that create a material conflict of interest, describe these practices and discuss the material conflicts of interest these practices create and how you address them.

Item 11 Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading

A. If you are an SEC-registered adviser, briefly describe your code of ethics adopted pursuant to SEC rule 204A-1 or similar state rules. Explain that you will provide a copy of your code of ethics to any *client* or prospective *client* upon request.

B. If you or a *related person* recommends to *clients*, or buys or sells for *client* accounts, securities in which you or a *related person* has a material financial interest, describe your practice and discuss the conflicts of interest it presents. Describe generally how you address conflicts that arise.

Examples: (1) You or a *related person*, as principal, buys securities from (or sells securities to) your *clients*; (2) you or a *related person* acts as general partner in a partnership in which you solicit *client* investments; or (3) you or a *related person* acts as an investment adviser to an investment company that you recommend to *clients*.

C. If you or a *related person* invests in the same securities (or related securities, *e.g.*, warrants, options or futures) that you or a *related person* recommends to *clients*, describe your practice and discuss the conflicts of interest this presents and generally how you address the conflicts that arise in connection with personal trading.

D. If you or a *related person* recommends securities to *clients*, or buys or sells securities for *client* accounts, at or about the same time that you or a *related person* buys or sells the same securities for your own (or the *related person's* own) account, describe your practice and discuss the conflicts of interest it presents. Describe generally how you address conflicts that arise.

Note: The description required by Item 11.A may include information responsive to Item 11.B, C or D. If so, it is not necessary to make repeated disclosures of the same information. You do not have to provide disclosure in response to Item 11.B, 11.C, or 11.D with respect to securities that are not "reportable securities" under SEC rule 204A-1(e)(10) and similar state rules.

Item 12 Brokerage Practices

A. Describe the factors that you consider in selecting or recommending broker-dealers for *client* transactions and determining the reasonableness of their compensation (*e.g.*, commissions).

1. Research and Other Soft Dollar Benefits. If you receive research or other products or services other than execution from a broker-dealer or a third party in connection with *client* securities transactions ("soft dollar benefits"), disclose your practices and discuss the conflicts of interest they create.

   Note: Your disclosure and discussion must include all soft dollar benefits you receive, including, in the case of research, both proprietary research (created or developed by the broker-dealer) and research created or developed by a third party.

   a. Explain that when you use *client* brokerage commissions (or markups or markdowns) to obtain research or other products or services, you receive a benefit because you do not have to produce or pay for the research, products or services.

   b. Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving the research or other products or services, rather than on your *clients*' interest in receiving most favorable execution.

c. If you may cause *clients* to pay commissions (or markups or markdowns) higher than those charged by other broker-dealers in return for soft dollar benefits (known as paying-up), disclose this fact.

d. Disclose whether you use soft dollar benefits to service all of your *clients'* accounts or only those that paid for the benefits. Disclose whether you seek to allocate soft dollar benefits to *client* accounts proportionately to the soft dollar credits the accounts generate.

e. Describe the types of products and services you or any of your *related persons* acquired with *client* brokerage commissions (or markups or markdowns) within your last fiscal year.

Note: This description must be specific enough for your *clients* to understand the types of products or services that you are acquiring and to permit them to evaluate possible conflicts of interest. Your description must be more detailed for products or services that do not qualify for the safe harbor in section 28(e) of the Securities Exchange Act of 1934, such as those services that do not aid in investment decision-making or trade execution. Merely disclosing that you obtain various research reports and products is not specific enough.

f. Explain the procedures you used during your last fiscal year to direct *client* transactions to a particular broker-dealer in return for soft dollar benefits you received.

2. Brokerage for *Client* Referrals. If you consider, in selecting or recommending broker-dealers, whether you or a *related person* receives *client* referrals from a broker-dealer or third party, disclose this practice and discuss the conflicts of interest it creates.

a. Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving *client* referrals, rather than on your *clients'* interest in receiving most favorable execution.

b. Explain the procedures you used during your last fiscal year to direct *client* transactions to a particular broker-dealer in return for *client* referrals.

3. Directed Brokerage.

a. If you routinely recommend, request or require that a *client* direct you to execute transactions through a specified broker-dealer, describe your practice or policy. Explain that not all advisers require their *clients* to direct brokerage. If you and the broker-dealer are affiliates or have another economic relationship that creates a material conflict of interest, describe the relationship and discuss the conflicts of interest it presents. Explain that by directing brokerage you may be unable to achieve most favorable execution of *client* transactions, and that this practice may cost *clients* more money.

b. If you permit a *client* to direct brokerage, describe your practice. If applicable, explain that you may be unable to achieve most favorable execution of *client* transactions. Explain that directing brokerage may cost *clients* more money. For example, in a directed brokerage account, the *client* may pay higher brokerage commissions because you may not be able to aggregate orders to reduce transaction costs, or the *client* may receive less favorable prices.

Note: If your *clients* only have directed brokerage arrangements subject to most favorable execution of *client* transactions, you do not need to respond to the last sentence of Item 12.A.3.a. or to the second or third sentences of Item 12.A.3.b.

B. Discuss whether and under what conditions you aggregate the purchase or sale of securities for various *client* accounts. If you do not aggregate orders when you have the opportunity to do so, explain your practice and describe the costs to *clients* of not aggregating.

Item 13 Review of Accounts

A. Indicate whether you periodically review *client* accounts or financial plans. If you do, describe the frequency and nature of the review, and the titles of the *supervised persons* who conduct the review.

B. If you review *client* accounts on other than a periodic basis, describe the factors that trigger a review.

C. Describe the content and indicate the frequency of regular reports you provide to *clients* regarding their accounts. State whether these reports are written.

Item 14 *Client* Referrals and Other Compensation

A. If someone who is not a *client* provides an economic benefit to you for providing investment advice or other advisory services to your *clients*, generally describe the arrangement, explain the conflicts of interest, and describe how you address the conflicts of interest. For purposes of this Item, economic benefits include any sales awards or other prizes.

B. If you or a *related person* directly or indirectly compensates any *person* who is not your *supervised person* for *client* referrals, describe the arrangement and the compensation.

Note: If you compensate any *person* for *client* referrals, you should consider whether SEC rule 206(4)-3 or similar state rules regarding solicitation arrangements and/or state rules requiring registration of *investment adviser representatives* apply.

Item 15 *Custody*

If you have *custody* of *client* funds or securities and a qualified custodian sends quarterly, or more frequent, account statements directly to your *clients*, explain that *clients* will receive account statements from the broker-dealer, bank or other qualified custodian and that *clients* should carefully review those statements. If your *clients* also receive account statements from you, your explanation must include a statement urging *clients* to compare the account statements they receive from the qualified custodian with those they receive from you.

Item 16 Investment Discretion

If you accept *discretionary authority* to manage securities accounts on behalf of *clients*, disclose this fact and describe any limitations *clients* may (or customarily do) place on this authority. Describe the procedures you follow before you assume this authority (*e.g.*, execution of a power of attorney).

Item 17 Voting *Client* Securities

A. If you have, or will accept, authority to vote *client* securities, briefly describe your voting policies and procedures, including those adopted pursuant to SEC rule 206(4)-6. Describe whether (and, if so, how) your *clients* can direct your vote in a particular solicitation. Describe how you address conflicts of interest between you and your *clients* with respect to voting their securities. Describe how *clients* may obtain information from you about how you voted their securities. Explain to *clients* that they may obtain a copy of your proxy voting policies and procedures upon request.

B. If you do not have authority to vote *client* securities, disclose this fact. Explain whether *clients* will receive their proxies or other solicitations directly from their custodian or a transfer agent or from you, and discuss whether (and, if so, how) *clients* can contact you with questions about a particular solicitation.

Item 18 Financial Information

A. If you require or solicit prepayment of more than $1,200 in fees per *client*, six months or more in advance, include a balance sheet for your most recent fiscal year.

1. The balance sheet must be prepared in accordance with generally accepted accounting principles, audited by an independent public accountant, and accompanied by a note stating the principles used to prepare it, the basis of securities included, and any other explanations required for clarity.

2. Show parenthetically the market or fair value of securities included at cost.

3. Qualifications of the independent public accountant and any accompanying independent public accountant's report must conform to Article 2 of SEC Regulation S-X.

Note: If you are a sole proprietor, show investment advisory business assets and liabilities separate from other business and personal assets and liabilities. You may aggregate other business and personal assets unless advisory business liabilities exceed advisory business assets.

Note: If you have not completed your first fiscal year, include a balance sheet dated not more than 90 days prior to the date of your *brochure*.

Exception: You are not required to respond to Item 18.A of Part 2A if you also are: (i) a qualified custodian as defined in SEC rule 206(4)-2 or similar state rules; or (ii) an insurance company.

B. If you have *discretionary authority* or *custody* of *client* funds or securities, or you require or solicit prepayment of more than $1,200 in fees per *client*, six months or more in advance, disclose any financial condition that is reasonably likely to impair your ability to meet contractual commitments to *clients*.

Note: With respect to Items 18.A and 18.B, if you are registered or are registering with one or more of the *state securities authorities*, the dollar amount reporting threshold for including the required balance sheet and for making the required financial condition disclosures is more than $500 in fees per *client*, six months or more in advance.

C. If you have been the subject of a bankruptcy petition at any time during the past ten years, disclose this fact, the date the petition was first brought, and the current status.

If you are registering or are registered with one or more *state securities authorities*, you must respond to the following additional Item.

Item 19 Requirements for State-Registered Advisers

A. Identify each of your principal executive officers and *management persons*, and describe their formal education and business background. If you have supplied this information elsewhere in your Form ADV, you do not need to repeat it in response to this Item.

B. Describe any business in which you are actively engaged (other than giving investment advice) and the approximate amount of time spent on that business. If you have supplied this information elsewhere in your Form ADV, you do not need to repeat it in response to this Item.

C. In addition to the description of your fees in response to Item 5 of Part 2A, if you or a *supervised person* are compensated for advisory services with *performance-based fees*, explain how these fees will be calculated. Disclose specifically that performance-based compensation may create an incentive for the adviser to recommend an investment that may carry a higher degree of risk to the *client*.

D. If you or a *management person* has been *involved* in one of the events listed below, disclose all material facts regarding the event.

1. An award or otherwise being *found* liable in an arbitration claim alleging damages in excess of $2,500, *involving* any of the following:

   (a) an investment or an *investment-related* business or activity;
   (b) fraud, false statement(s), or omissions;
   (c) theft, embezzlement, or other wrongful taking of property;
   (d) bribery, forgery, counterfeiting, or extortion; or
   (e) dishonest, unfair, or unethical practices.

2. An award or otherwise being *found* liable in a civil, *self-regulatory organization*, or administrative *proceeding involving* any of the following:

   (a) an investment or an *investment-related* business or activity;
   (b) fraud, false statement(s), or omissions;
   (c) theft, embezzlement, or other wrongful taking of property;
   (d) bribery, forgery, counterfeiting, or extortion; or
   (e) dishonest, unfair, or unethical practices.

E. In addition to any relationship or arrangement described in response to Item 10.C. of Part 2A, describe any relationship or arrangement that you or any of your *management persons* have with any issuer of securities that is not listed in Item 10.C. of Part 2A.

Instructions for Part 2A Appendix 1 of Form ADV: Preparing Your *Wrap Fee Program Brochure*

Read all the instructions, including General Instructions for Form ADV, General Instructions for Part 2 of Form ADV, Instructions for Part 2A of Form ADV, and the instructions below, before preparing or updating your *wrap fee program brochure*.

1. Who must deliver a *wrap fee program brochure*? If you *sponsor* a *wrap fee program*, you must give a *wrap fee program brochure* to each *client* of the *wrap fee program*.

   However, if a *wrap fee program* that you *sponsor* has multiple *sponsors* and another *sponsor* creates and delivers to your *wrap fee program clients* a *wrap fee program brochure* that includes all the information required in your *wrap brochure,* you do not have to create or deliver a separate *wrap fee program brochure.*

   A *wrap fee program brochure* takes the place of your advisory firm *brochure* required by Part 2A of Form ADV, but only for *clients* of *wrap fee programs* that you *sponsor.* See SEC rule 204-3(d) and similar state rules.

2. When must a *wrap fee program brochure* be delivered?

   - You must give a *wrap fee program brochure* to each *client* of the *wrap fee program* before or at the time the *client* enters into a *wrap fee program* contract. See SEC rule 204-3(b) and similar state rules.
   - Each year you must (i) deliver, within 120 days of the end of your fiscal year, to each *client* a free updated *wrap fee program brochure* that either includes a summary of material changes or is accompanied by a summary of material changes, or (ii) deliver to each *client* a summary of material changes that includes an offer to provide a copy of the updated *wrap fee program brochure* and information on how a *client* may obtain the *wrap fee program brochure.* See SEC rule 204-3(b) and similar state rules.
   - You do not have to deliver an interim amendment to *clients* unless the amendment includes information in response to Item 9 of Part 2A (disciplinary information). An interim amendment can be in the form of a document describing the material facts relating to the amended disciplinary event. See SEC rule 204-3(b) and similar state rules.

   Note: As a fiduciary, you have an ongoing obligation to inform your *clients* of any material information that could affect the advisory relationship. As a result, between *annual updating amendments* you must disclose material changes to such information to *clients* even if those changes do not trigger delivery of an interim amendment. See General Instructions for Part 2 of Form ADV, Instruction 3.

3. When must we update our *wrap fee program brochure*? You must update your *wrap fee program brochure*: (i) each year at the time you file your *annual updating amendment*, and (ii) promptly whenever any information in the *wrap fee program brochure* becomes materially inaccurate. You are not required to update your *wrap fee program brochure* between annual amendments solely because your fee schedule has changed. However, if you are updating your *wrap fee program brochure* for a separate reason in between annual amendments, and your fee schedule listed in response to Item 4.A has become materially inaccurate, you should update that item as part of the interim amendment. All updates to your *wrap fee program brochure* must be filed through the IARD system and maintained in your files. See SEC rules 204-1 and 204-2(a)(14) and similar state rules.

4. May we deliver our *wrap fee program brochure* electronically? Yes. The SEC has published interpretive guidance on delivering documents electronically, which you can find at <www.sec.gov/rules/concept/33-7288.txt>.

5. What if we *sponsor* more than one *wrap fee program*? You may prepare a single *wrap fee program brochure* describing all the *wrap fee programs* you *sponsor*, or you may prepare separate *wrap fee program brochures* that describe one or more of your *wrap fee programs.* If you prepare separate *brochures*, each *brochure* must state that you *sponsor* other *wrap fee programs* and must explain how the *client* can obtain *brochures* for the other programs.

6. We provide portfolio management services under a *wrap fee program* that we *sponsor*. Must we deliver both our *wrap fee program brochure* and our firm *brochure* to our *wrap fee program clients*? No, just the *wrap fee program brochure*. If you or your *supervised persons* provide portfolio management services under a *wrap fee program* that you also *sponsor*, your *wrap fee program brochure* must describe the investments and investment strategies you (or your *supervised persons*) will use as portfolio managers. This requirement appears in Item 6.C of this Appendix.

7. We provide other advisory services outside of our *wrap fee programs*. May we combine our *wrap fee program brochure* into our firm *brochure* for *clients* receiving these other services? No. Your *wrap fee program brochure* must address only the *wrap fee programs* you *sponsor*. See SEC rule 204-3(d)(1) and similar state rules.

8. Must we also deliver *brochure supplements* to *wrap fee program clients*? Yes. A *wrap fee program brochure* does not take the place of any supplements required by Part 2B of Form ADV.

Part 2A Appendix 1 of Form ADV: ***Wrap Fee Program Brochure***

Item 1 Cover Page

A. The cover page of your *wrap fee program brochure* must state your name, business address, contact information, web site address (if you have one), and the date of the *wrap fee program brochure.*

Note: If you primarily conduct advisory business under a name different from your full legal name, and you have disclosed your business name in Item 1.B of Part 1A of Form ADV, then you may use your business name throughout your *wrap fee program brochure.*

B. Display on the cover page of your *wrap fee program brochure* the following (or other clear and concise language conveying the same information) and identifying the document as a "wrap fee program brochure":

This wrap fee program brochure provides information about the qualifications and business practices of [your name]. If you have any questions about the contents of this brochure, please contact us at [telephone number and/or email address]. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Additional information about [your name] also is available on the SEC's website at www.adviserinfo.sec.gov.

D. If you refer to yourself as a "registered investment adviser" or describe yourself as being "registered," include a statement that registration does not imply a certain level of skill or training.

Item 2 Material Changes

If you are amending your *wrap fee program brochure* for your annual update and it contains material changes from your last annual update, identify and discuss those changes on the page immediately following the cover page of the *wrap fee program brochure* or as a separate document accompanying the *brochure.* You must clearly state that you are discussing only material changes since the last annual update of the *wrap fee program brochure*, and must provide the date of the last annual update to the *wrap fee program brochure.*

Notes: You do not have to provide this information to a *client* or prospective *client* who has not received a previous version of your *wrap fee program brochure.*

Item 3 Table of Contents

Provide a table of contents to your *wrap fee program brochure.*

Note: Your table of contents must be detailed enough so that your *clients* can locate topics easily. Your *wrap fee program brochure* must follow the same order, and contain the same headings, as the items listed in this Appendix 1.

Item 4 Services, Fees and Compensation

A. Describe the services, including the types of portfolio management services, provided under each program. Indicate the wrap fee charged for each program or, if fees vary according to a schedule, provide your fee schedule. Indicate whether fees are negotiable and identify the portion of the total fee, or the range of fees, paid to portfolio managers.

Cwli.

B. Explain that the program may cost the *client* more or less than purchasing such services separately and describe the factors that bear upon the relative cost of the program, such as the cost of the services if provided separately and the trading activity in the *client's* account.

C. Describe any fees that the *client* may pay in addition to the wrap fee, and describe the circumstances under which *clients* may pay these fees, including, if applicable, mutual fund expenses and mark-ups, mark-downs, or spreads paid to market makers.

D. If the *person* recommending the *wrap fee program* to the *client* receives compensation as a result of the *client's* participation in the program, disclose this fact. Explain, if applicable, that the amount of this compensation may be more than what the *person* would receive if the *client* participated in your other programs or paid separately for investment advice, brokerage, and other services. Explain that the *person*, therefore, may have a financial incentive to recommend the *wrap fee program* over other programs or services.

Item 5 Account Requirements and Types of *Clients*

If a *wrap fee program* imposes any requirements to open or maintain an account, such as a minimum account size, disclose these requirements. If there is a minimum amount for assets placed with each portfolio manager as well as a minimum account size for participation in the *wrap fee program*, disclose and explain these requirements. To the extent applicable to your *wrap fee program clients*, describe the types of *clients* to whom you generally provide investment advice, such as individuals, trusts, investment companies, or pension plans.

Item 6 Portfolio Manager Selection and Evaluation

A. Describe how you select and review portfolio managers, your basis for recommending or selecting portfolio managers for particular *clients*, and your criteria for replacing or recommending the replacement of portfolio managers for the program and for particular *clients*.

1. Describe any standards you use to calculate portfolio manager performance, such as industry standards or standards used solely by you.

2. Indicate whether you review, or whether any third-party reviews, performance information to determine or verify its accuracy or its compliance with presentation standards. If so, briefly describe the nature of the review and the name of any third party conducting the review.

3. If applicable, explain that neither you nor a third-party reviews portfolio manager performance information, and/or that performance information may not be calculated on a uniform and consistent basis.

B. Disclose whether any of your *related persons* act as a portfolio manager for a *wrap fee program* described in the *wrap fee program brochure*. Explain the conflicts of interest that you face because of this arrangement and describe how you address these conflicts of interest. Disclose whether *related person* portfolio managers are subject to the same selection and review as the other portfolio managers that participate in the *wrap fee program*. If they are not, describe how you select and review *related person* portfolio managers.

C. If you, or any of your *supervised persons* covered under your investment adviser registration, act as a portfolio manager for a *wrap fee program* described in the *wrap fee program brochure*, respond to Items 4.B, 4.C, 4.D (Advisory Business), 6 (*Performance-Based Fees* and Side-By-Side Management), 8.A (Methods of Analysis, Investment Strategies and Risk of Loss) and 17 (Voting *Client* Securities) of Part 2A of Form ADV.

Item 7 *Client* Information Provided to Portfolio Managers

Describe the information about *clients* that you communicate to the *clients*' portfolio managers, and how often or under what circumstances you provide updated information.

Item 8 *Client* Contact with Portfolio Managers

Explain any restrictions placed on *clients*' ability to contact and consult with their portfolio managers.

Item 9 Additional Information

A. Respond to Item 9 (Disciplinary Information) and Item 10 (Other Financial Industry Activities and Affiliations) of Part 2A of Form ADV.

B. Respond to Items 11 (Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading), 13 (Review of Accounts), 14 (*Client* Referrals and Other Compensation), and 18 (Financial Information) of Part 2A of Form ADV, as applicable to your wrap fee *clients*.

If you are registered or are registering with one or more *state securities authorities*, you must respond to the following additional Item.

Item 10 Requirements for State-Registered Advisers

Respond to Item 19.E of Part 2A of Form ADV.

ESN.

Instructions for Part 2B of Form ADV: Preparing a *Brochure Supplement*

1. For which *supervised persons* must we prepare a *brochure supplement*? As an initial matter, if you have no *clients* to whom you must deliver a *brochure supplement* (see Instruction 2 below), then you need not prepare any *brochure supplements*. Otherwise, you must prepare a *brochure supplement* for the following *supervised persons*:

   (i) Any *supervised person* who formulates investment advice for a *client* and has direct *client* contact; and

   (ii) Any *supervised person* who has *discretionary authority* over a *client's* assets, even if the *supervised person* has no direct *client* contact. See SEC rule 204-3(b)(2) and similar state rules.

   Note: No supplement is required for a *supervised person* who has no direct *client* contact and has *discretionary authority* over a *client*'s assets only as part of a team. In addition, if discretionary advice is provided by a team comprised of more than five *supervised persons*, *brochure supplements* need only be provided for the five *supervised persons* with the most significant responsibility for the day-to-day discretionary advice provided to the *client*. See SEC rule 204-3(b) and similar state rules.

2. To whom must we deliver *brochure supplements*? Are there any exceptions?

   You must deliver to a *client* the *brochure supplements* for each *supervised person* who provides advisory services to that *client*. However, there are three categories of *clients* to whom you are not required to deliver *supplements*. See SEC rule 204-3(c) and similar state rules.

   First, you are not required to deliver supplements to *clients* to whom you are not required to deliver a firm *brochure* (or a *wrap fee program brochure*).

   Second, you are not required to deliver supplements to *clients* who receive only *impersonal investment advice*, even if they receive a firm *brochure*.

   Third, you are not required to deliver supplements to *clients* who are individuals who would be "qualified clients" of your firm under SEC rule 205-3(d)(1)(iii). Those *persons* are:

   (i) Any executive officers, directors, trustees, general partners, or *persons* serving in a similar capacity, of your firm; or

   (ii) Any employees of your firm (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of your firm and have been performing such functions or duties for at least 12 months.

3. When must we deliver a supplement to a *client*?

- You must deliver the supplement for a *supervised person* before or at the time that *supervised person* begins to provide advisory services to a *client*.
- You also must deliver to *clients* any update to the supplement that amends information in response to Item 3 of Part 2B (disciplinary information). Such an amendment can be in the form of a "sticker" that identifies the information that has become inaccurate and provides the new information and the date of the sticker.

  Note: As a fiduciary, you have a continuing obligation to inform your *clients* of any material information that could affect the advisory relationship. As a result, between *annual updating amendments* you must disclose material changes to *clients* even if those changes do not trigger delivery of an updated supplement.

You may have a *supervised person* deliver supplements (including his own) on your behalf. Furthermore, if you are an SEC-registered adviser, you not required to file *brochure supplements* or updates, but you must maintain copies of them. See Instruction 5 of SEC General Instructions for Part 2 of Form ADV.

4. When must we update *brochure supplements*? You must update *brochure supplements* promptly whenever any information in them becomes materially inaccurate.

5. May we deliver *brochure supplements* electronically? Yes. You may deliver supplements using electronic media. The SEC has published interpretive guidance on delivering documents electronically, which you can find at <www.sec.gov/rules/concept/33-7288.txt>. If you deliver a supplement electronically, you may disclose in that supplement that the *supervised person* has a disciplinary event and provide a hyperlink to either the BrokerCheck or the IAPD systems.

6. Must *brochure supplements* be separate documents? No. If your firm *brochure* includes all the information required in a *brochure supplement*, you do not need a separate supplement. Smaller firms with just a few *supervised persons* may find it easier to include all supplement information in their firm *brochure*, while larger firms may prefer to use a firm *brochure* and separate supplements. If supplement information is included in the firm *brochure*, however, the supplements must be included at the end of the brochure. In addition, each supplement must follow the same order as the supplement items listed in Part 2B, and contain the same headings.

   You may prepare supplements for groups of *supervised persons*. A group supplement, or a firm *brochure* presenting supplement information about *supervised persons*, must present information in a separate section for each *supervised person*.

7. Must an adviser who is a sole proprietor provide his own *brochure supplement* to *clients*? No, if that information is included in the firm *brochure*.

8. May we include information not required by an item in a *brochure supplement*? Yes. If you include information not required by an item, however, you may not include so much additional information that the required information is obscured.

9. Are we required to file the *brochure supplements*? If you are registered or are registering with the SEC, you are not required to file your *brochure supplements*, but you are required to maintain copies of all supplements and amendments to supplements in your files. See SEC rule 204-2(a)(14)(i). If you are registered or are registering with one or more *state securities authorities*, you must file through IARD a copy of the *brochure supplement* for each *supervised person* doing business in that state.

Part 2B of Form ADV: *Brochure Supplement*

Item 1 Cover Page

A. Include the following on the cover page of the supplement:

1. The *supervised person's* name, business address and telephone number (if different from yours).
2. Your firm's name, business address and telephone number. If your firm *brochure* uses a business name for your firm, use the same business name for the firm in the supplement.
3. The date of the supplement.

B. Display on the cover page statements containing the following or other clear and concise language conveying the same information, and identifying the document as a "brochure supplement:"

This brochure supplement provides information about [name of *supervised person*] that supplements the [name of advisory firm] brochure. You should have received a copy of that brochure. Please contact [service center or name and/or title of your contact *person*] if you did not receive [name of advisory firm]'s brochure or if you have any questions about the contents of this supplement.

Additional information about [name of *supervised person*] is available on the SEC's website at www.adviserinfo.sec.gov.

Note: You do not have to include this statement directing *clients* to the public website unless the *supervised person* is an *investment adviser representative* required to register with *state securities authorities*. The above information must be on the cover page of the supplement but need not be the only information on the cover page of the supplement. If other information is included on the cover page of the supplement, the above information must be on the top of the first page of the supplement.

Item 2 Educational Background and Business Experience

Disclose the *supervised person's* name, age (or year of birth), formal education after high school, and business background (including an identification of the specific positions held) for the preceding five years. If the *supervised person* has no high school education, no formal education after high school, or no business background, disclose this fact. You may list any professional designations held by the *supervised person*, but if you do so, you must provide a sufficient explanation of the minimum qualifications required for each designation to allow *clients* to understand the value of the designation.

Item 3 Disciplinary Information

If there are legal or disciplinary events material to a *client's* or prospective *client's* evaluation of the *supervised person,* disclose all material facts regarding those events.

Items 3.A, 3.B, 3.C, and 3.D below list specific legal and disciplinary events presumed to be material for this Item. If the *supervised person* has been *involved* in one of these events, you must disclose it under this Item for ten years following the date of the event, unless (1) the event was resolved in the *supervised person's* favor, or was reversed, suspended or vacated, or (2) you have rebutted the presumption of materiality to determine that the event is not material (see Note below). For purposes of calculating this ten-year period, the "date" of an event is the date the final *order*, judgment, or decree was entered, or the date any rights of appeal from preliminary *order*s, judgments or decrees lapsed.

Items 3.A, 3.B, 3.C, and 3.D do not contain an exclusive list of material disciplinary events. If the *supervised person* has been *involved* in a legal or disciplinary event that is not listed in Items 3.A, 3.B, 3.C, or 3.D but is material to a *client's* or prospective *client's* evaluation of the *supervised person's* integrity, you must disclose the

event. Similarly, even if more than ten years have passed since the date of the event, you must disclose the event if it is so serious that it remains currently material to a *client's* or prospective *client's* evaluation. If you deliver a supplement electronically and if a particular disclosure required below for the *supervised person* is provided through either the Financial Industry Regulatory Authority's (FINRA) BrokerCheck system or the IAPD, you may satisfy that particular disclosure obligation by including in that supplement (i) a statement that the *supervised person* has a disciplinary history, the details of which can be found on FINRA's BrokerCheck system or the IAPD, and (ii) a hyperlink to the relevant system with a brief explanation of how the *client* can access the disciplinary history. The BrokerCheck link is www.finra.org/brokercheck; the IAPD link is www.adviserinfo.sec.gov.

A. A criminal or civil action in a domestic, foreign or military court of competent jurisdiction in which the *supervised person*

   1. was convicted of, or pled guilty or nolo contendere ("no contest") to (a) any *felony*; (b) a *misdemeanor* that *involved* investments or an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, or extortion; or (c) a conspiracy to commit any of these offenses;

   2. is the named subject of a pending criminal *proceeding* that involves an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses;

   3. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation; or

   4. was the subject of any *order*, judgment, or decree permanently or temporarily enjoining, or otherwise limiting, the *supervised person* from engaging in any *investment-related* activity, or from violating any *investment-related* statute, rule, or *order*.

B. An administrative *proceeding* before the SEC, any other federal regulatory agency, any state regulatory agency, or any *foreign financial regulatory authority* in which the *supervised person*

   1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

   2. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation and was the subject of an *order* by the agency or authority

      (a) denying, suspending, or revoking the authorization of the *supervised person* to act in an *investment-related* business;

      (b) barring or suspending the *supervised person's* association with an *investment-related* business;

      (c) otherwise significantly limiting the *supervised person's investment-related* activities; or

      (d) imposing a civil money penalty of more than $2,500 on the *supervised person*.

C. A *self-regulatory organization* (*SRO*) *proceeding* in which the *supervised person*

   1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

   2. was *found* to have been *involved* in a violation of the *SRO's* rules and was: (i) barred or suspended from membership or from association with other members, or was expelled from membership; (ii) otherwise significantly limited from *investment-related* activities; or (iii) fined more than $2,500.

D. Any other *proceeding* in which a professional attainment, designation, or license of the *supervised person* was revoked or suspended because of a violation of rules relating to professional conduct. If the *supervised person* resigned (or otherwise relinquished his attainment, designation, or license) in anticipation of such a *proceeding* (and the adviser knows, or should have known, of such resignation or relinquishment), disclose the event.

Note: You may, under certain circumstances, rebut the presumption that a disciplinary event is material. If an event is immaterial, you are not required to disclose it. When you review a legal or disciplinary event involving the *supervised person* to determine whether it is appropriate to rebut the presumption of materiality, you should consider all of the following factors: (1) the proximity of the *supervised person* to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time elapsed since the date of the disciplinary event. If you conclude that the materiality presumption has been overcome, you must prepare and maintain a file memorandum of your determination in your records. See SEC rule 204-2(a)(14)(iii) and similar state rules.

Item 4 Other Business Activities

A. If the *supervised person* is actively engaged in any *investment-related* business or occupation, including if the *supervised person* is registered, or has an application pending to register, as a broker-dealer, registered representative of a broker-dealer, futures commission merchant ("FCM"), commodity pool operator ("CPO"), commodity trading advisor ("CTA"), or an associated *person* of an FCM, CPO, or CTA, disclose this fact and describe the business relationship, if any, between the advisory business and the other business.

1. If a relationship between the advisory business and the *supervised person's* other financial industry activities creates a material conflict of interest with *clients*, describe the nature of the conflict and generally how you address it.

2. If the *supervised person* receives commissions, bonuses or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative, and including distribution or service ("trail") fees from the sale of mutual funds, disclose this fact. If this compensation is not cash, explain what type of compensation the *supervised person* receives. Explain that this practice gives the *supervised person* an incentive to recommend investment products based on the compensation received, rather than on the *client's* needs.

B. If the *supervised person* is actively engaged in any business or occupation for compensation not discussed in response to Item 4.A, above, and the other business activity or activities provide a substantial source of the *supervised person's* income or involve a substantial amount of the *supervised person's* time, disclose this fact and describe the nature of that business. If the other business activities represent less than 10 percent of the *supervised person's* time and income, you may presume that they are not substantial.

Item 5 Additional Compensation

If someone who is not a *client* provides an economic benefit to the *supervised person* for providing advisory services, generally describe the arrangement. For purposes of this Item, economic benefits include sales awards and other prizes, but do <u>not</u> include the *supervised person's* regular salary. Any bonus that is based, at least in part, on the number or amount of sales, *client* referrals, or new accounts should be considered an economic benefit, but other regular bonuses should not.

Item 6 Supervision

Explain how you *supervise* the *supervised person*, including how you monitor the advice the *supervised person* provides to *clients*. Provide the name, title and telephone number of the *person* responsible for supervising the *supervised person's* advisory activities on behalf of your firm.

If you are registered or are registering with one or more *state securities authorities*, you must respond to the following additional Item.

Item 7 Requirements for State-Registered Advisers

A. In addition to the events listed in Item 3 of Part 2B, if the *supervised person* has been *involved* in one of the events listed below, disclose all material facts regarding the event.

1. An award or otherwise being *found* liable in an arbitration claim alleging damages in excess of $2,500, *involving* any of the following:

(a) an investment or an *investment-related* business or activity;
(b) fraud, false statement(s), or omissions;
(c) theft, embezzlement, or other wrongful taking of property;
(d) bribery, forgery, counterfeiting, or extortion; or
(e) dishonest, unfair, or unethical practices.

2. An award or otherwise being *found* liable in a civil, *self-regulatory organization*, or administrative *proceeding involving* any of the following:

(a) an investment or an *investment-related* business or activity;
(b) fraud, false statement(s), or omissions;
(c) theft, embezzlement, or other wrongful taking of property;
(d) bribery, forgery, counterfeiting, or extortion; or
(e) dishonest, unfair, or unethical practices.

B. If the *supervised person* has been the subject of a bankruptcy petition, disclose that fact, the date the petition was first brought, and the current status.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62586 / July 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13982

In the Matter of T&W Financial Corp., Talger Management, Inc., TCom Ventures Corp. (f/k/a Telecom Wireless Corp.), TEQ-1 Corp., Tesseract Group, Inc., TexMont, Inc., Thunderbird Mining, Milling & Chemical Corp., and TK Originals, 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 T&W Financial Corp., Talger Management, Inc., TCom Ventures Corp. (f/k/a Telecom Wireless Corp.), TEQ-1 Corp., Tesseract Group, Inc., TexMont, Inc., Thunderbird Mining, Milling & Chemical Corp., and TK Originals, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. T&W Financial Corp. (CIK No. 1041077) is an inactive Washington corporation located in Tacoma, Washington with a class of securities registered with the

43 of 47

Commission pursuant to Exchange Act Section 12(g). T&W 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, 1999, which reported a net loss of $291,000 for the prior nine months. On October 31, 2000, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Western District of Washington, which was terminated on September 23, 2004.

2. Talger Management, Inc. (CIK No. 1097233) is a void Delaware corporation located in Surrey, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Talger 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 May 31, 2000, which reported a net loss of $17 for the prior three months.

3. TCom Ventures Corp. (f/k/a Telecom Wireless Corp.) (CIK No. 1098923) is a void Delaware corporation located in Englewood, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). U.S. Biomedical 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, 2000, which reported a net loss of over $18 million for the prior nine months. As of July 20, 2010, the company's stock (symbol "TCMV") was traded on the over-the-counter markets.

4. TEQ-1 Corp. (CIK No. 1111865) is a permanently revoked Nevada corporation located in West Jordan, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). TEQ-1 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, 2002, which reported a net loss of $9,415 since the company's November 19, 1997 inception.

5. Tesseract Group, Inc. (CIK No. 873601) is an inactive Minnesota corporation located in Phoenix, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Tesseract 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, 2000, which reported a net loss of over $13 million for the prior nine months. On October 6, 2000, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Arizona, which was terminated on July 14, 2006. As of July 20, 2010, the company's stock (symbol "TSSTQ") was traded on the over-the-counter markets.

6. TexMont, Inc. (CIK No. 1072287) is a permanently revoked Nevada corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). TexMont 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 May 31, 2001, which reported a net loss of $15,037 since the company's June 25, 1998 inception.

7. Thunderbird Mining, Milling & Chemical Corp. (CIK No. 1128961) is a dissolved Arizona corporation located in Salt Lake City, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Thunderbird is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB registration statement on December 1, 2000, which reported a net loss of $17,000 since the company's January 13, 1992 inception.

8. TK Originals, Inc. (CIK No. 1090099) is a permanently revoked Nevada corporation located in West Valley City, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). TK 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 February 28, 2001, which reported a net loss of $11,111 for the prior nine months.

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 issuers to file quarterly reports.

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

III.

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

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

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

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. 62589 / July 29, 2010

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3160 / July 29, 2010

ADMINISTRATIVE PROCEEDING
FILE NO. 3-13983

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

I.

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

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, the subject matter of these proceedings, and the findings contained in Section III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to

[1] Rule 102(e)(3)(i) provides, in relevant part, that: The Commission, with due regard to the public interest and without preliminary hearing, may, by order, … suspend from appearing or practicing before it any … accountant … who has been by name … permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Hulse, age 54, is and has been a certified public accountant licensed to practice in the State of Maryland. Hulse became the Chief Financial Officer ("CFO") of Sunrise Sunrise Senior Living, Inc. ("Sunrise" or the "Company") in March 2000. On August 4, 2005, Sunrise announced that it had replaced Hulse as CFO and Hulse became chief executive of Sunrise's captive insurance company. On December 20, 2007, Sunrise announced the separation of Hulse from the Company.

2. Sunrise is a Delaware Corporation headquartered in McLean, Virginia. Its securities are registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and the Company's common stock trades on the New York Stock Exchange under the symbol SRZ. Sunrise is a provider of residential communities and services for the elderly. Sunrise has a fiscal year end of December 31.

3. On July 23, 2010, the Commission filed a complaint against Hulse and others in *Securities and Exchange Commission v. Sunrise Senior Living, Inc., et al.* Civil Action No.1:10-CV-01247 (D.D.C.). On July 27, 2010 the court entered an order permanently enjoining Hulse, by consent, from future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act") and Section 13(b)(5) of the Exchange Act and Rules 13a-14 and 13b2-1 thereunder and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder. Hule was also ordered by consent to pay $83,333 in disgorgement of ill-gotten gains plus $31,660 in prejudgment interest and a $50,000 civil monetary penalty.

4. The Commission's complaint alleged, among other things, that Hulse, in violation of Generally Accepted Accounting Principles, oversaw improper adjustments to Sunrise's reserve for self-insured health and dental benefits and its accrual for corporate bonuses, thereby misrepresenting Sunrise's earnings. The complaint alleges that as a result of his actions, Sunrise filed materially false and misleading financial statements for Sunrise's 2003 and 2004 fiscal years on Forms 10-K and in Sunrise's quarterly reports on Forms 10-Q for the first two quarters of 2005. The complaint further alleges that Hulse signed false SEC filings and Sarbanes Oxley certifications.

IV.

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

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

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

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

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

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62591 / July 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13984

In the Matter of

Daren L. Palmer,

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 Daren L. Palmer ("Respondent").

II.

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

III.

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

1. Palmer, age 40, is a resident of Idaho Falls, Idaho. Palmer owned Trigon Group, Inc. ("Trigon"), a Nevada corporation not registered with the Commission, and controlled its operations from at least 1997 through February 26, 2009. Palmer has never been registered with the Commission in any capacity and has never been licensed to sell securities. From at least 1996 until October 2008, Palmer was acting as an unregistered broker.

2. On July 19, 2010, a final judgment was entered by consent against Palmer, permanently enjoining him from future violations of Sections 17(a), 5(a) and (c) of the Securities Act of 1933 ("Securities Act") and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Daren L. Palmer, et al., Civil Action Number CV09-075-S-EJL, in the United States District Court for the District of Idaho.

3. The Commission's Complaint alleged that Palmer sold securities in the form of promissory notes and investment contracts to investors in unregistered, non-exempt transactions raising at least $40 million. The Complaint further alleged that in connection with the sale of these securities, Palmer made material misrepresentations and omissions regarding investment risks and how investment funds would be used. The Complaint also alleged that Palmer misused and misappropriated investor funds, falsely told investors that their funds were invested in S&P 500 options, futures, and stocks, sent out false account statements indicating that investors were earning high returns, and otherwise engaged in a variety of conduct which operated as a fraud and deceit on investors.

IV.

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

Accordingly, it is hereby ORDERED:

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Aguilar
Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 62593 / July 29, 2010

ADMINISTRATIVE PROCEEDING
File No. 3-13985

In the Matter of

GARY L. CRITTENDEN and ARTHUR H. TILDESLEY, JR.

Respondents.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING CEASE-AND-DESIST ORDERS

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 Gary L. Crittenden ("Crittenden") and Arthur H. Tildesley, Jr. ("Tildesley").

II.

In anticipation of the institution of these proceedings, Crittenden has submitted an Offer of Settlement of Gary L. Crittenden ("Crittenden Offer") and Tildesley has submitted an Offer of Settlement of Arthur H. Tildesley, Jr. ("Tildesley Offer"), which offers the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Crittenden and Tildesley consent 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 Cease-and-Desist Orders ("Order"), as set forth below.

46 of 47

III.

On the basis of this Order, Crittenden's Offer, and Tildesley's Offer, the Commission finds[1] that:

A. SUMMARY

In late September and early October 2007, Crittenden, the chief financial officer ("CFO") of Citigroup Inc. ("Citigroup") and Tildesley, the head of Citigroup's Investor Relations ("IR") department, both helped draft and then approved, and Crittenden subsequently made, misstatements about the exposure to sub-prime mortgages of Citigroup's investment bank. Citigroup then included a transcript of the misstatements in a Form 8-K that it filed with the Commission on October 1, 2007. The misstatements were made at a time of heightened investor and analyst interest in public company exposure to sub-prime mortgages and related to disclosures that the Citigroup investment bank had reduced its sub-prime exposure from $24 billion at the end of 2006 to slightly less than $13 billion. In fact, however, in addition to the approximately $13 billion in disclosed sub-prime exposure, the investment bank's sub-prime exposure included more than $39 billion of "super senior" tranches of sub-prime collateralized debt obligations and related instruments called "liquidity puts" and thus exceeded $50 billion. Citigroup did not acknowledge that the investment bank's sub-prime exposure exceeded $50 billion until November 4, 2007, when the company announced that the investment bank then had approximately $55 billion of sub-prime exposure.

By including a transcript containing the misstatements in a Form 8-K, Citigroup violated Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-11. As a result of the role that they played, Crittenden and Tildesley each was a cause of Citigroup's violation.

B. RESPONDENTS

Respondent Gary L. Crittenden, age 57, resides in Salt Lake City, Utah. After serving as CFO of several large public companies, Crittenden joined Citigroup in March 2007 as the Citigroup's CFO. He remained Citigroup's CFO until March 2009. He then became head of a Citigroup unit known as Citi Holdings and held that position until July 2009. In July 2009, Crittenden left Citigroup.

Respondent Arthur H. Tildesley, Jr., age 49, resides in Fair Haven, New Jersey. Tildesley joined a predecessor of Citigroup in 1986 and has remained with the company, now known as Citigroup, subsequent to that time. In 2003, after working for several years in Citigroup's

[1] The findings herein are made pursuant to the Crittenden Offer and the Tildesley Offer and are not binding on any other person or entity in this or any other proceeding.

investment bank, Tildesley joined Citigroup's IR department and became head of that department in September 2004. Tildesley remained head of IR until February 2008. He then became chief administrative officer of Citigroup's Global Wealth Management division. Tildesley subsequently became, and remains, Citigroup's head of Global Cross Marketing. At all times relevant to these proceedings, Tildesley reported directly to Crittenden.

C. RELEVANT ENTITY

Citigroup is a Delaware corporation with its principal place of business in New York, New York. Citigroup is a global financial services company that provides a broad range of financial services to consumer and corporate clients. During the time relevant to these proceedings, the company was organized into the following five divisions: Global Consumer Group; Markets & Banking; Global Wealth Management; Alternative Investments; and Corporate/Other. Citigroup's United States residential mortgage-related assets were held primarily within the Consumer Lending division, which was part of the Global Consumer Group, and within the investment bank, which was part of the Securities and Banking business, which in turn was part of Markets & Banking. Citigroup's securities are registered with the Commission under Section 12(b) of the Exchange Act, and the company's common stock is listed on the New York Stock Exchange, the Tokyo Stock Exchange, and the Mexico Stock Exchange. Citigroup reports its results on a calendar-year basis.

D. FACTS

1. Background

During 2006 and continuing into 2007, the price of homes in the United States stopped rising and began to decline; new housing starts and existing home sales declined; and defaults on mortgages, particularly sub-prime mortgages, increased. As a result of these developments, there was increasing investor and analyst interest in the amount of residential mortgage-related assets that Citigroup held and, in particular, Citigroup's exposure to what were known as sub-prime mortgage-related assets.

During the time in 2007 relevant to these proceedings, Citigroup held residential mortgage-related assets primarily in its investment bank and its Consumer Lending business. Within the Consumer Lending business, these assets included prime and sub-prime mortgages that the Consumer Lending business originated or purchased from third parties and then securitized or held. Within the investment bank, these assets included sub-prime mortgages that Citigroup purchased for securitization or trading, sub-prime mortgage-related assets held as collateral for financing provided by Citigroup, sub-prime mortgage-backed securities that Citigroup "warehoused" for future inclusion in collateralized debt obligations, and tranches of previously structured collateralized debt obligations.

A collateralized debt obligation ("CDO") is a type of asset-backed security collateralized by a pool of fixed income assets, such as sub-prime mortgage-backed securities, and issued by a bankruptcy-remote special purpose vehicle ("SPV"). A CDO is structured into tranches with each tranche representing a different level of risk and return. The most senior tranche generally is known as the "super senior" tranche and typically represents between sixty and eighty percent of the capital structure of the CDO. Below the super senior tranche are one or more senior tranches, one or more mezzanine tranches, and an equity tranche. All of the tranches have the same underlying collateral. The super senior tranche has the highest priority claim on the cash flows from that collateral. The equity tranche has the lowest priority claim and receives payments only after all of the higher tranches have been paid in full. The senior and mezzanine tranches are rated by rating agencies; the equity tranche is not rated. Due to its first priority claim to the cash flows from the CDO's collateral, as well as other structural features, the super senior tranche historically was considered the safest tranche from a credit risk perspective. Because the super senior tranche was considered safer than the most senior of the senior tranches and because that senior tranche was rated AAA, the highest available rating from the rating agencies, the super senior tranche typically was not rated. Due primarily to the large size and relatively low yield of the super senior tranche, a limited number of potential purchasers for that tranche existed, and the super senior tranche typically did not trade in the secondary market.

Citigroup's CDO structuring business included advising asset managers on collateral selection and CDO structuring, providing CDO warehouses, underwriting CDO offerings and placing CDOs with investors, as well as trading CDOs in the secondary market. Prior to a CDO closing, the assets purchased for the CDO are held in what is referred to as a CDO warehouse. Upon closing of the CDO, the assets are transferred from the warehouse to an SPV in exchange for the proceeds of the sale of the CDO tranches. Citigroup earned fees in connection with its CDO structuring business.

Certain of the CDOs that Citigroup structured and underwrote as part of its CDO business included a feature known as a "liquidity put." The liquidity put was an instrument that obligated Citigroup under certain circumstances to purchase commercial paper backed by the super senior tranche of a CDO. Under the terms of the liquidity put arrangement, Citigroup's obligation to purchase that commercial paper would be triggered if there was a dramatic drop in demand for the commercial paper such that the commercial paper issuer, i.e., the CDO, was unable to re-issue the commercial paper below a certain interest rate. For Citigroup, owning the commercial paper essentially would be the economic equivalent of holding the super senior tranche that backed the commercial paper.

2. The Responsibilities of Crittenden and Tildesley with Respect to the Contents of Citigroup's Public Announcements of Quarterly Results

At the end of each quarter, Citigroup's investment bank and other businesses gathered information about each business's financial performance for the quarter. Each business prepared a document that described significant developments and the results of the business for the quarter. The document was referred to within Citigroup as a "Flash Deck." During the relevant time in

2007, the Flash Deck for Citigroup's investment bank included a section prepared by Citigroup's Risk Management organization that set forth information about the sources and amount of risk to which the investment bank was exposed as well as steps that the investment bank had taken to mitigate risk.

The Flash Decks that Citigroup's businesses prepared were used in conjunction with what were known as "Flash Calls." The Flash Calls, in turn, were to prepare the CFO and other members of senior management, members of IR, and others for the public release of the company's earnings. After the end of each quarter, representatives of each business made an oral presentation about the business's financial performance for the quarter to Citigroup corporate-level personnel that included Crittenden, Tildesley and one or more other members of IR, the corporate controller, representatives of the Financial Planning and Analysis department, and representatives of the Risk Management organization. Before or during the Flash Calls, the participants were provided with a copy of the Flash Decks that the businesses had prepared.

For each quarter of 2007, Crittenden and Tildesley attended the Flash Calls and were provided with the Flash Decks that Citigroup's investment bank and other businesses prepared. The Flash Decks for each quarter included information that was used for, among other things, the preparation of the press release announcing Citigroup's earnings for the quarter ("earnings release") as well as the script for senior management to use for the quarterly conference call with investors and analysts to discuss the company's results for the quarter ("earnings script").

Following the quarterly Flash Calls, representatives of IR often communicated with representatives of Citigroup's businesses to obtain additional information that they believed was needed to prepare (a) the earnings release, (b) a deck of slides containing quarterly financial information to be released with the earnings release, (c) the earnings script, and (d) a list of questions and answers to be used internally to prepare for questions that might be asked during the conference call with investors and analysts.

Also following the Flash Calls, Crittenden met with Tildesley and members of senior management to discuss information that should be included in the earnings script. As head of IR, Tildesley oversaw the drafting of the earnings script and the earnings release and gave IR's approval of those documents. Crittenden also reviewed drafts of these documents and approved the final versions of them.

3. First and Second Quarters of 2007

As Citigroup prepared to announce its earnings for the first quarter of 2007, senior management and senior personnel in IR, including Crittenden and Tildesley, gathered information in order to have responses to anticipated questions about the investment bank's sub-prime exposure from analysts and others. Senior management and IR personnel requested information from the investment bank and, in response, were provided with documents and other information detailing the investment bank's sub-prime exposure.

The sub-prime assets of Citigroup's investment bank were located primarily in two of the investment bank's business units: Global Securitized Markets ("GSM"), which did not hold CDOs, and Global Structured Credit Products ("GSCP"), which did hold CDOs. In responding to the request for information on sub-prime exposure, the investment bank provided Crittenden, Tildesley, and others with documents that showed that GSM had approximately $10.1 billion of sub-prime exposure and that, excluding certain sub-prime assets related to secondary trading and market making activities ("trading exposure"), GSCP had approximately $7 billion of sub-prime exposure. One of the documents provided, entitled "Overview of Subprime Exposure in the Global Structured Credit Product Business," also showed that GSCP had an additional $37.8 billion in sub-prime exposure from super senior tranches of CDOs ($14.6 billion) and liquidity puts ($23.2 billion). The document, however, included an explanation that the investment bank considered the risk of default on the super senior tranches and the liquidity puts to be "extremely small" and that it therefore "excluded" the $37.8 billion amount from its internal analysis of GSCP's sub-prime exposure. When Citigroup subsequently announced its results for the first quarter of 2007, it did not disclose the investment bank's sub-prime exposure, and the topic was not raised during a conference call with investors and analysts to discuss the company's results for the quarter.

As the second quarter of 2007 ended, there again was consideration of making disclosures about the Citigroup investment bank's sub-prime exposure. Citigroup senior management and IR personnel, including Crittenden and Tildesley, again sought and received information about that exposure. During a Flash Call on July 10, 2007, Crittenden, Tildesley, and others received a Flash Deck from the investment bank. The Flash Deck included a table prepared by the company's Risk Management organization that showed the investment bank's sub-prime "Exposures" as of the end of the second quarter of 2007. That table showed, among other things, that the investment bank's sub-prime exposure included more than $33 billion of exposure from super senior tranches of CDOs and liquidity puts.

Also on July 10, 2007, at Crittenden's request, representatives of Citigroup's investment bank had a separate meeting with Crittenden, Tildesley, and one or more other individuals to discuss GSCP's sub-prime exposure. During this meeting, the investment bank representatives provided a document entitled "Overview of Subprime Exposure in the Global Structured Credit Products Business" that was an updated version of the document provided in April 2007. The updated document showed that, excluding trading exposure, GSCP had approximately $4.7 billion of sub-prime exposure. In addition, the document showed that there was approximately $39 billion in sub-prime exposure from super senior tranches of CDOs ($14.7 billion) and liquidity puts ($24.5 billion). The document again showed that the investment bank was excluding the $39 billion in exposure from the super senior tranches and the liquidity puts from its internal analysis of GSCP's sub-prime exposure because the investment bank considered the risk of default on those items to be "extremely small." Contemporaneous documents reflect discussion on July 10 of $12 billion of sub-prime exposure; the documents do not reflect whether there was any discussion of the super senior tranches of CDOs or the liquidity puts.

On July 19, 2007, Crittenden and Tildesley participated in a meeting with senior Citigroup personnel to finalize disclosures related to sub-prime for the company's upcoming earnings call. Tildesley's contemporaneous notes concerning the amount of the investment bank's sub-prime exposure reflect only discussion of the approximately $13 billion of sub-prime assets. The notes do not reflect whether there was any discussion of the super senior tranches of CDOs or the liquidity puts.

On July 20, 2007, Citigroup issued a press release announcing the company's earnings for the second quarter of 2007 and conducted a telephone conference call with investors and analysts to discuss the company's results for the second quarter ("July 20 Earnings Call"). One week later, on July 27, 2007, Citigroup conducted its semi-annual Fixed Income Investor Review conference call ("July 27 Fixed Income Call") with investors and analysts. During both the July 20 Earnings Call and the July 27 Fixed Income Call, there was discussion of the Citigroup investment bank's sub-prime exposure. In the July 20 Earnings Call, it was represented that the investment bank's sub-prime exposure could be divided into two categories, "secured lending" and "trading"; that the company had been managing down the exposure from secured lending; and that the investment bank had reduced the assets in secured lending from $24 billion at the end of 2006 to $20 billion at the end of the first quarter of 2007 and to $13 billion at the end of the second quarter of 2007.[2] In the July 27 Fixed Income Call, it again was stated that the investment bank had reduced its sub-prime exposure to $13 billion. The Citigroup investment bank's sub-prime exposure was materially understated during both the July 20 Earnings Call and the July 27 Fixed Income Call primarily because, with the super senior tranches of CDOs and the liquidity puts, the investment bank's sub-prime exposure in secured lending exceeded $50 billion at the end of the second quarter of 2007 rather than the $13 billion that was disclosed.

4. <u>Third Quarter of 2007</u>

During the third quarter of 2007, the housing market in the United States continued to deteriorate, and defaults on sub-prime mortgages increased. Due at least in part to investor concerns over a lack of transparency about the potential sub-prime exposure of commercial paper issuers, the demand for asset-backed commercial paper fell dramatically. As a result, Citigroup believed that the issuers of the commercial paper that was backed by the super senior tranches of CDOs would exercise the liquidity puts and require Citigroup to purchase the commercial paper. In anticipation of the exercise of the liquidity puts, Citigroup, beginning in August 2007, purchased the commercial paper that had the liquidity put feature described above. By mid-September 2007, Citigroup had purchased approximately $25 billion, substantially all, of the commercial paper backed by super senior tranches of sub-prime CDOs. Crittenden was aware of these purchases; Tildesley was informed of at least some of these purchases.

[2] There was no disclosure of the amount of the investment bank's sub-prime exposure that was in the trading category. The super senior tranches of CDOs and the liquidity puts, however, were not part of the trading category.

Also during the third quarter of 2007, Tildesley, in his role as head of IR, was aware of the ongoing and increasing investor and analyst interest in the size of Citigroup's and other banks' sub-prime exposure. In July and August 2007, a limited number of the analyst reports that Tildesley and others received quantified Citigroup's sub-prime exposure by referencing the $13 billion figure discussed during the July 20 Earnings Call.

As a result of the continuing decline in the value of, and the lack of liquidity for, sub-prime-related securities during the third quarter of 2007, Citigroup re-examined its method of valuing the super senior tranches of sub-prime CDOs. By the end of August 2007, the valuation methods the company was considering showed potential losses ranging from approximately $15 million to over $2 billion. Citigroup continued to work on its valuation methods, including through consultation by the investment bank and the Risk Management organization with Crittenden and others. Tildesley did not participate in the valuation process.

As part of the valuation process, in early September 2007, Crittenden met with the head of Citigroup's Risk Management organization and others to discuss the valuation issues related to the super senior tranches of sub-prime CDOs. At the meeting, Crittenden was provided with a document entitled "Super Senior Valuation and Potential P&L Impact." Among other things, the document showed, and the meeting participants discussed, that based on different potential valuation methodologies, Citigroup could have third quarter 2007 losses ranging from $43 million to $1.35 billion on the more than $16 billion of super senior tranches that the investment bank then held. Following the meeting, Crittenden directed financial personnel in the investment bank to oversee a process to determine the appropriate valuation methodology. Because of anticipated losses resulting from what the company characterized as "dislocations in the mortgage-backed securities and credit markets and a deterioration in the consumer credit environment," which included the anticipated losses on the super senior tranches, Citigroup concluded that there would be a substantial decline in the company's anticipated net income for the third quarter of 2007. Citigroup therefore decided to issue a pre-announcement of its third quarter financial results.

After Citigroup decided to issue the pre-announcement of its expected third quarter 2007 results, Crittenden, Tildesley, and others began working on a script for a recorded call with investors and analysts and an accompanying press release. During this time, Crittenden referred to the super senior tranches of CDOs as one of the "critical issues" and a "major issue" to be resolved before the pre-announcement. Tildesley wrote the initial draft of the portion of the pre-announcement script relating to sub-prime and CDOs. The initial draft of the pre-announcement script did not include any reference to the super senior tranches or the liquidity puts. Following preparation of the initial draft, Crittenden met with an IR officer to discuss the script and requested that a reference to the "highest-rated tranches" of CDO be added; Crittenden did not request that the amount of the super senior tranches and the liquidity puts be referenced. After this meeting, additional work on the script was performed and references to "highest-rated tranches" and to CDOs' experiencing declines in value during the third quarter of 2007 were added.[3] By this time,

[3] The reference to the highest-rated tranches was an apparent reference to the super senior tranches.

both Tildesley and Crittenden had received information showing that Citigroup was anticipating approximately $300 million in write-downs on the value of the super senior tranches.

On September 27, 2007, a pre-announcement was recorded. At the time, Citigroup was expecting that the write-down in the value of the super senior tranches of CDOs would be approximately $300 million. Shortly after the recording of the pre-announcement, however, it was determined that there had been an error in the model that had been used to calculate the value of the super senior tranches and that the amount of the write-down was approximately $100 million. Tildesley then informed Crittenden that due to the change in the write-downs of the super senior tranches, Crittenden would have to re-record that part of the pre-announcement.

Following the decision to re-record the pre-announcement, there was an electronic mail message ("e-mail") exchange, which did not include Crittenden, during which the following language was circulated to Tildesley other members of IR, a senior officer, and representatives of the investment bank:

> We typically have sold the lowest rated tranches of the CDOs and held onto most of the highest rated tranches, which historically have enjoyed more stable valuations. As the subprime problem spread across various security types, we started to see valuation declines even in the highest rated tranches.

The proposed draft continued:

> Starting in January of this year, we began to lower our exposure to these sub-prime assets as we saw the market changing. At the beginning of this year we had $24 billion of secured sub-prime exposure in our lending and structuring business. That number was $13 billion at the end of June, and declined slightly this quarter. Despite our aggressive efforts this year to work these positions down and to put in place appropriate hedges, we were still holding mortgage assets in our warehouse, or holding undistributed tranches of CDOs, when the market dislocated. And although we had hedged, this only partially offset our losses, which netted to a write-down of approximately $1.0 billion.

In reviewing that draft pre-announcement script, an investment bank officer, in an e-mail sent to Tildesley and others, noted the potential for a listener to the announcement to conclude that the investment bank's sub-prime exposure was only $13 billion. An IR officer responded that, because the super senior tranches of CDOs previously had not been discussed in the prior disclosures and because of a request by the investment bank that the IR officer understood to be a request not to discuss those tranches, there was no choice other than to let listeners conclude that the investment bank's total sub-prime exposure was $13 billion. In response to that assessment, the investment bank officer suggested removing the discussion about the highest rated tranches so as to avoid eliciting questions about super seniors. Another investment bank

executive agreed with that suggestion, and noted that the write-down in the value of the super senior tranches had declined. Tildesley took no action with respect to the issue that had been raised.

Following the e-mail exchange described above, the script for the pre-announcement call was finalized. As finalized, the script included a statement that the company held on to "most of the highest rated tranches" but then did not include disclosure of the amount of the investment bank's sub-prime exposure from the super senior tranches of CDOs and the liquidity puts. Crittenden and Tildesley reviewed and approved the final version of the script.

On October 1, 2007, Citigroup issued a press release and a recorded telephone announcement in which the company pre-announced expected financial results for the third quarter of 2007. In the press release, the company announced that its Securities and Banking business, which included the investment bank, had experienced pre-tax losses of approximately $1.3 billion, net of hedges, on its sub-prime exposure from CDOs and related securities and from leveraged loans warehoused for future securitizations. Citigroup did not provide a breakdown of the approximately $1.3 billion in losses, but the amount included approximately $300 million in losses from leveraged loans warehoused for future collateralized loan obligation securitizations and approximately $1 billion in losses on sub-prime exposure. The approximately $1 billion in losses on the sub-prime exposure, in turn, included approximately $100 million in losses on the super senior tranches of CDOs.

In the October 1, 2007 recorded telephone announcement ("October 1 Pre-Announcement Call"), Crittenden made the following prepared statements about the Citigroup investment bank's sub-prime exposure:

> [W]e took significant write-downs in the value of mortgage-backed securities in the 'warehouses' and CDOs..
>
> This is a business where we accumulate pools of mortgages or mortgage backed securities (mostly sub-prime) and hold them in a warehouse until we have sufficient assets to create a CDO for sale in the market.
>
> We typically have sold the lowest rated tranches of the CDOs and held onto most of the highest rated tranches, where historically values have been stable. In July, however, actions by the rating agencies which involved methodology changes and downgrades of certain CDO tranches caused investors to suddenly pull back from the entire CDO market, resulting in a rapid decline in CDO values.
>
> Starting in January of this year, we began to lower our exposure to these sub-prime assets as we saw the market changing. At the beginning of the year we had $24 billion of secured sub-

prime exposure in our lending and structuring business. That number was $13 billion at the end of June, and declined slightly this quarter. Despite our aggressive efforts this year to work these positions down, and to put in place appropriate hedges, we were still holding mortgage assets in our warehouse, or holding undistributed tranches of CDOs, when the market dislocated. Although hedging activity produced gains, they only partially offset our losses, which netted to a write-down of approximately $1.0 billion.

Also on October 1, 2007, Citigroup filed a Current Report on Form 8-K ("October 1 Form 8-K") with the Commission. Citigroup included the October 1 press release and a transcript of the October 1 Pre-Announcement Call in that October 1 Form 8-K. Citigroup incorporated by reference the October 1 Form 8-K into certain registration statements that the company filed, including shelf registration statements on Form S-3ASR filed on March 2, 2006, March 13, 2006, and June 20, 2006, and a registration statement on Form S-8 filed on May 4, 2005.

The statements about the amount of the Citigroup investment bank's sub-prime exposure made during the October 1 Pre-Announcement Call, and included in the October 1 Form 8-K, did not disclose what was then approximately $43 billion of sub-prime exposure from the super senior tranches of CDOs ($18 billion) and the liquidity puts ($25 billion). By referencing the retention of the "highest rated tranches" of CDOs, the disclosure suggested that the investment bank's entire sub-prime exposure was slightly less than $13 billion. By October 1, 2007, however, the investment bank's sub-prime exposure was not slightly less than $13 billion but was approximately $55 billion. As such, on the October 1 Pre-Announcement Call, the investment bank's sub-prime exposure was materially understated. After the October 1 Pre-Announcement Call, several analyst reports and newspaper articles reported that the Citigroup investment bank's sub-prime exposure was $13 billion or slightly less than that amount.

5. Citigroup Discloses that Its Investment Bank Has $55 Billion in Sub-Prime Exposure

Following the earnings pre-announcements and the filing of the October 1 Form 8-K, Citigroup worked on finalizing its results for the third quarter of 2007. On October 15, 2007, Citigroup issued a press release and held a conference call with investors and analysts to announce and discuss the company's results for the third quarter of 2007. During the October 15, 2007 conference call ("October 15 Earnings Call"), it again was represented that the Citigroup investment bank's sub-prime exposure was $24 billion at the beginning of 2007, was $13 billion at the end of the second quarter of 2007, and had declined slightly during the third quarter of the year.[4] The investment bank's sub-prime exposure was materially understated during the October 15 Earnings Call because, with the super senior tranches of CDOs and the liquidity puts, the

[4] By the time of the October 15 Earnings Call, Citigroup had determined that the write-downs on the super senior tranches of CDOs for the third quarter of 2007 were approximately $300 million rather than the approximately $100 million that had been determined at the time of the October 1 Pre-Announcement Call.

investment bank's sub-prime exposure in secured lending exceeded $50 billion at the end of the third quarter of 2007 rather than the approximately $13 billion that was disclosed.

Following the October 15, 2007 press release and the October 15 Earnings Call, certain rating agencies downgraded tranches of sub-prime-backed CDOs. These downgrades followed earlier rating agency downgrades of certain mortgage-backed securities. Particularly due to the rating agency downgrades that took place after October 15, 2007, Citigroup determined that the downgrades would have a negative effect on the value of the super senior and other CDO tranches and the liquidity puts. The company estimated that the losses would be in the range of $8 billion to $11 billion for the fourth quarter of 2007. The company then decided to disclose the range of loss and the amount of the investment bank's sub-prime exposure, including the super senior tranches and the liquidity puts.

On November 4, 2007, Citigroup issued a press release in which, for the first time, the company disclosed an amount for the investment bank's sub-prime exposure that included the amount of the exposure from the super senior tranches and the liquidity puts. The company announced that it had experienced

> significant declines since September 30, 2007 in the fair value of the approximately $55 billion in U.S. sub-prime related direct exposures in its Securities and Banking (S&B) business. Citi estimates that, at the present time, the reduction in revenues attributable to these declines ranges from approximately $8 billion to $11 billion (representing a decline of approximately $5 billion to $7 billion in net income on an after-tax basis).

The company also specifically disclosed that the $55 billion included $43 billion in exposure from the super senior tranches of CDOs and the liquidity puts. In addition, the company disclosed that, due to a correction of its earlier valuation, the losses on the super senior tranches and the liquidity puts for the third quarter of 2007 had increased by $270 million. As a result, the total losses attributable to the super senior tranches and the liquidity puts for the third quarter of 2007 were over $500 million.

E. <u>LEGAL ANALYSIS</u>

Section 13(a) of the Exchange Act and Exchange Act Rule 13a-11 require issuers of securities registered pursuant to Section 12 of the Exchange Act, such as Citigroup, to file with the Commission accurate periodic reports, including current reports Form 8-K. An issuer violates these provisions if it files a report that is not complete, accurate, and timely. *See SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 72 (D.C. Cir. 1980); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978). Rule 12b-20 further requires that periodic reports contain any material information necessary to make the required statements made in the reports not misleading.

The statements about the Citigroup investment bank's sub-prime exposure made during the October 1 Pre-Announcement Call were materially misleading because the investment bank's sub-prime exposure was not $13 billion at the end of the second quarter of 2007 and slightly less than that amount at the end of the third quarter of 2007, as represented, but rather exceeded $50 billion. As a result of the inclusion of a transcript of the October 1 Pre-Announcement Call in the October 1 Form 8-K, the October 1 Form 8-K was materially misleading. Citigroup, therefore, violated Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-11. Based on the information that they had at the time, Crittenden and Tildesley each should have known that the statements made during the October 1 Pre-Announcement Call were materially misleading. Under these circumstances and in light of the roles that they played in the misstatements made during the October 1 Pre-Announcement Call, which then were included in the October 1 Form 8-K, Crittenden and Tildesley each was a cause of Citigroup's violation.

F. UNDERTAKINGS

Crittenden has undertaken to pay $100,000.00. Crittenden will make this payment within ten (10) days of the issuance of this Order. 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 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 Crittenden as a respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and wire transfer instructions, money order, or check shall be sent to Andrew H. Feller, Esq. Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-5010. The Commission shall remit the funds paid pursuant to this paragraph to the United States Treasury. In determining whether to accept the Crittenden Offer, the Commission has considered this undertaking by Crittenden.

Tildesley has undertaken to pay $80,000.00. Tildesley will make this payment within ten (10) days of the issuance of this Order. 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 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 Tildesley as a respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and wire transfer instructions, money order, or check shall be sent to Andrew H. Feller, Esq. Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-5010. The Commission shall remit the funds paid pursuant to this paragraph to the United States Treasury. In determining whether to accept the Tildesley Offer, the Commission has considered this undertaking by Tildesley.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions to which Crittenden agreed in the Crittenden Offer and to which Tildesley agreed in the Tildesley Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 21C of the Exchange Act, Crittenden and Tildesley each shall cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-11.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro and Commissioner Walter not participating

SECURITIES AND EXCHANGE COMMISSION

[Investment Company Act Release No. 29374; File No. 812-13807]

GE Asset Management Incorporated and GE Investment Distributors, Inc.; Notice of Application and Temporary Order

July 30, 2010

Agency: Securities and Exchange Commission ("Commission").

Action: Temporary order and notice of application for a permanent order under section 9(c) of the Investment Company Act of 1940 ("Act").

Summary of Application: Applicants have received a temporary order exempting them from section 9(a) of the Act, with respect to an injunction entered against General Electric Company ("GE"), Ionics, Inc. ("Ionics"), and Amersham plc ("Amersham") on July 30, 2010, by the United States District Court for the District of Columbia ("Injunction"), until the Commission takes final action on an application for a permanent order. Applicants also have applied for a permanent order.

Applicants: GE Asset Management Incorporated ("GEAM") and GE Investment Distributors, Inc. ("GEID", collectively with GEAM, the "Applicants").[1]

Filing Dates: The application was filed on July 27, 2010, and amended on July 30, 2010.

Hearing or Notification of Hearing: An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving Applicants with a copy of the request, personally

[1] Applicants request that any relief granted pursuant to the application also apply to any other company of which GE, Ionics, or Amersham is or may become an affiliated person (together with the Applicants, the "Covered Persons").

or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on August 24, 2010, and should be accompanied by proof of service on Applicants, in the form of an affidavit, or for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; Applicants: 3001 Summer Street, Stamford, CT 06904-7900.

For Further Information Contact: Courtney S. Thornton, Senior Counsel, at (202) 551-6812, or Mary Kay Frech, Branch Chief, at (202) 551-6821, (Division of Investment Management, Office of Investment Company Regulation).

Supplementary Information: The following is a temporary order and a summary of the application. The complete application may be obtained via the Commission's Website by searching for the file number, or an applicant using the Company name box, at http://www.sec.gov/search/search.htm, or by calling (202) 551-8090.

Applicants' Representations:

1. GE is a large diversified technology, media, and financial services company. GEAM, a Delaware corporation, is a direct, wholly-owned subsidiary of GE. GEAM is registered as an investment adviser under the Investment Advisers Act of 1940 and serves as investment adviser to a number of registered investment companies

("Funds"), including employees' securities companies ("ESCs").[2] GEID is, through GEAM, an indirect, wholly-owned subsidiary of GE. GEID is registered as a broker-dealer under the Securities Exchange Act of 1934 and is a member of the Financial Industry Regulatory Authority, Inc. GEID serves as principal underwriter to a number of Funds.

2. On July 30, 2010, the United States District Court for the District of Columbia entered a final judgment, which included the Injunction, against GE, Ionics, and Amersham ("Judgment") in a matter brought by the Commission.[3] The Commission alleged in the complaint ("Complaint") that, from 2000 to 2003, four current subsidiaries of GE, including Ionics and Amersham, which were both acquired by GE after the conduct at issue in the Complaint, authorized and made payments in the form of cash, medical equipment, and services to Iraqi government ministries through agents on sales of products to Iraq under the United Nations Oil for Food Program. Without admitting or denying the allegations in the Complaint, except as to jurisdiction, GE, Ionics, and Amersham consented to the entry of the Judgment that included, among other things, the entry of the Injunction. In addition, the Judgment ordered GE, on behalf of itself, Ionics, and Amersham, to pay disgorgement in the amount of approximately $18.4 million, plus prejudgment interest of approximately $4 million, and a civil penalty of $1 million.

Applicants' Legal Analysis:

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[2] The ESCs, as defined in section 2(a)(13) of the Act, are open-end management investment companies registered under the Act and provide investment opportunities for certain employees, officers, and directors of GEAM and its affiliates, and other eligible participants.

[3] Securities and Exchange Commission v. General Electric Company, Final Judgment as to General Electric Company, 1:10-cv-1258 (RWR) (D.D.C. July 30, 2010).

1. Section 9(a)(2) of the Act, in relevant part, prohibits a person who has been enjoined from, among other things, engaging in or continuing any conduct or practice in connection with the purchase or sale of a security, or in connection with activities as an underwriter, broker or dealer, from acting, among other things, as an investment adviser or depositor of any registered investment company or a principal underwriter for any registered open-end investment company, registered unit investment trust or registered face-amount certificate company. Section 9(a)(3) of the Act makes the prohibition in section 9(a)(2) applicable to a company, any affiliated person of which has been disqualified under the provisions of section 9(a)(2). Section 2(a)(3) of the Act defines "affiliated person" to include, among others, any person directly or indirectly controlling, controlled by, or under common control with, the other person. Applicants state that each of GE, Ionics, and Amersham is an affiliated person of each of the Applicants within the meaning of section 2(a)(3) of the Act. Applicants state that the entry of the Injunction results in Applicants being subject to the disqualification provisions of section 9(a) of the Act.

2. Section 9(c) of the Act provides that the Commission shall grant an application for exemption from the disqualification provisions of section 9(a) if it is established that these provisions, as applied to the applicants, are unduly or disproportionately severe or that the applicants' conduct has been such as not to make it against the public interest or the protection of investors to grant the exemption. Applicants have filed an application pursuant to section 9(c) seeking a temporary and permanent order exempting them and other Covered Persons from the disqualification provisions of section 9(a) of the Act.

3. Applicants believe they meet the standard for exemption specified in section 9(c). Applicants state that the prohibitions of section 9(a) as applied to them would be unduly and disproportionately severe and that the conduct of the Applicants has been such as not to make it against the public interest or the protection of investors to grant the exemption from section 9(a).

4. Applicants state that the alleged conduct giving rise to the Injunction did not involve either of the Applicants acting in the capacity of investment adviser, subadviser or depositor for any Fund or as principal underwriter for any Fund, and no such Funds bought or held any securities issued by the Covered Persons during the period of misconduct alleged in the Complaint, other than with respect to index Funds and certain international Funds holding securities issued by Amersham prior to its acquisition by GE. Applicants also state that none of the current or former directors, officers, or employees of the Applicants had any responsibility for, or involvement in, the violative conduct alleged in the Complaint. Applicants further state that the personnel at GE, Ionics, or Amersham who had any responsibility for, or involvement in, the violations alleged in the Complaint have had no, and will not have any future, involvement in providing investment advisory, subadvisory, or underwriting services to the Funds.

5. Applicants state that their inability to continue to provide investment advisory, subadvisory and underwriting services to the Funds would result in potential hardship for the Funds and their shareholders. Applicants state that they will, as soon as reasonably practical, distribute written materials, including an offer to meet in person to discuss the materials, to the boards of directors of the Funds ("Boards") for which the Applicants serve as investment adviser, investment subadviser or principal underwriter,

including the directors who are not "interested persons," as defined in section 2(a)(19) of the Act, of such Funds, and their independent legal counsel as defined in rule 0-1(a)(6) under the Act, relating to the circumstances that led to the Injunction, any impact on the Funds, and the application. Applicants state they will provide the Boards with all information concerning the Judgment and the application that is necessary for the Funds to fulfill their disclosure and other obligations under the federal securities laws.

6. Applicants also state that, if they were barred from providing services to the Funds, the effect on their businesses and employees would be severe. Applicants state that they have committed substantial resources to establishing expertise in providing advisory and distribution services to Funds. Applicants further state that prohibiting them from providing such services would not only adversely affect their businesses, but would also adversely affect about 500 employees who are involved in those activities.

7. In 2009, GEAM and GEID received an exemption under section 9(c) as a result of conduct by GE that triggered section 9(a), as described in greater detail in the application. A predecessor of one of the Applicants previously received an exemption under section 9(c) as the result of conduct that triggered section 9(a), as described in greater detail in the application.

Applicants' Condition:

Applicants agree that any order granting the requested relief will be subject to the following condition:

Any temporary exemption granted pursuant to the application shall be without prejudice to, and shall not limit the Commission's rights in any manner with respect to, any Commission investigation of, or administrative proceedings

involving or against, Covered Persons, including, without limitation, the consideration by the Commission of a permanent exemption from section 9(a) of the Act requested pursuant to the application or the revocation or removal of any temporary exemptions granted under the Act in connection with the application.

Temporary Order:

The Commission has considered the matter and finds that Applicants have made the necessary showing to justify granting a temporary exemption.

Accordingly,

IT IS HEREBY ORDERED, pursuant to section 9(c) of the Act, that GEAM and GEID and any other Covered Persons are granted a temporary exemption from the provisions of section 9(a), solely with respect to the Injunction, subject to the condition in the application, from July 30, 2010, until the Commission takes final action on their application for a permanent order.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary