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 **April 2011,** 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

(52 Documents)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
April 4, 2011

In the Matter of Centrack International, Inc., Alternafuels, Inc., Intelligent Medical Imaging, Inc., and Optimark Data Systems, 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 Centrack International, Inc. because it has not filed any periodic reports since the period ended February 28, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Alternafuels, Inc. because it has not filed any periodic reports since the period ended December 31, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Intelligent Medical Imaging, Inc. because it has not filed any periodic reports since the period ended September 30, 1999.

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

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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 April 4, 2011, through 11:59 p.m. EDT on April 15, 2011.

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

SECURI XCHANGE ACT OF 1934
Releas 69 / April 4, 2011

ATIVE PROCEEDING
4315

A

atter of

ack International, Inc.,
nafuels, Inc.,
lligent Medical Imaging, Inc., and
timark Data Systems, 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 Centrack International, Inc., Alternafuels, Inc., Intelligent Medical Imaging, Inc., and Optimark Data Systems, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Centrack International, Inc. ("CENK") [1] (CIK No. 1094220) is a forfeited Delaware corporation located in Boca Raton, Florida with a class of securities registered wit Commission pursuant to Exchange Act Section 12(g). CENK is delinquent in its periodic f with the Commission, having not filed any periodic reports since it filed a Form 10-QSB fo period ended February 28, 2002, which reported a net loss of $659,959 for the prior nine m As of March 30, 2011, the common stock of CENK was quoted on OTC Link, had five m makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)

[1] The short form of each issuer's name is also its stock symbol.

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2. Alternafuels, Inc. ("ALTFD") (CIK No. 826743) is a Florida corporation located in Tampa, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ALTFD is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2003. As of March 30, 2011, the common stock of ALTFD was quoted on OTC Link (formerly "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Intelligent Medical Imaging, Inc. ("IMIIQ") (CIK No. 930090) is a void Delaware corporation located in Palm Beach Gardens, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). IMIIQ 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 $10,783,580 for the prior nine months. On November 29, 1999, IMIQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Florida, which was terminated on August 18, 2005. As of March 30, 2011, the common stock of IMIIQ was quoted on OTC Link, had two market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Optimark Data Systems, Inc. ("OPMK") (CIK No. 941904) is a British Columbia corporation located in Tampa, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). OPMK is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended August 31, 1999, which reported a net loss of $121,815 Canadian for the prior nine months. As of March 30, 2011, the common stock of OPMK was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

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

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

III.

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

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

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

IV.

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

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

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64171 / April 4, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14316

In the Matter of	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934
Circuit Systems, Inc., Global Energy Group, Inc., Integrated Medical Resources, Inc., iNTELEFILM Corp., and Lot$off Corp., Respondents.	

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Circuit Systems, Inc., Global Energy Group, Inc., Integrated Medical Resources, Inc., iNTELEFILM Corp., and Lot$off Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Circuit Systems, Inc. ("CSYI") [1] (CIK No. 773657) is a bankrupt Illinois corporation located in Elk Grove Village, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CSYI is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended January 31, 2000, which reported a net loss of $3,084,330 for the prior nine months. On September 5, 2000, CSYI filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Illinois, which was terminated on December 22, 2006. As of March 30, 2011, the common stock of CSYI was quoted on OTC Link (formerly "Pink Sheets")

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[1] The short form of each issuer's name is also its stock symbol.

operated by OTC Markets Group Inc. ("OTC Link"), had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Global Energy Group, Inc. ("GENG") (CIK No. 1099358) is a delinquent Delaware corporation located in Plano, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GENG 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, 2006, which reported a net loss of $12,760,710 for the prior nine months. As of March 30, 2011, the common stock of GENG was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Integrated Medical Resources, Inc. ("IMRIQ") (CIK No. 918591) is a forfeited Kansas corporation located in Lenexa, Kansas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). IMRIQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1998, which reported a net loss of $10,304,403 for the prior nine months. On November 12, 1998, IMRIQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Kansas, which was converted to a Chapter 7 proceeding on December 1, 1998, and was terminated on May 8, 2007. As of March 30, 2011, the common stock of IMRIQ was quoted on OTC Link, had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. iNTELEFILM Corp. ("FILM") (CIK No. 882160) is a Minnesota corporation located in Wayzata, Minnesota with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FILM 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 $787,271 for the prior three months. On August 5, 2002, FILM filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Minnesota, which was terminated on May 13, 2004. As of March 30, 2011, the common stock of FILM was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Lot$off Corp. ("LOTS") (CIK No. 735584) is a void Delaware corporation located in San Antonio, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). LOTS 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 30, 1998, which reported a net loss of $6,285,163 for the prior thirty-nine weeks. On December 28, 1999, LOTS filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Western District of Texas, which was terminated on July 16, 2007. As of March 30, 2011, the common stock of LOTS was quoted on OTC Link, had two market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file

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

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

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

III.

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

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

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

IV.

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

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

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

OFFICE OF GOVERNMENT ETHICS

SECURITIES AND EXCHANGE COMMISSION

5 CFR Part 4401

[Release No. 34-64172]

Amendment of outside employment and activities section of the SEC's Supplemental Standards of Ethical Conduct for Members and Employees of the Securities and Exchange Commission

AGENCIES: Securities and Exchange Commission and Office of Government Ethics.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission with the concurrence of the Office of Government Ethics is amending its Supplemental Standards of Conduct for Members and Employees to eliminate a recently established prior approval requirement for outside employment.

DATES: Effective Date: [Insert date 30 days after date of publication in the Federal Register]

FOR FURTHER INFORMATION CONTACT: Shira Pavis Minton, Ethics Counsel, 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 amending its Supplemental Standards of Conduct for Members and Employees to eliminate a recently established prior approval requirement for outside employment. Staff members of the SEC are already subject to strict limitations regarding the type of employment they are allowed to undertake, and staff regularly seeks advice from the ethics office prior to taking any outside employment. In addition, the requirement appears to be largely cumulative of other measures without providing significant additional benefits. These other measures include the requirement that SEC staff members submit proposed publications or prepared speeches relating to the Commission (or to the statutes or rules it administers) to the General Counsel for review. These measures also include current financial disclosure regulations and current substantive regulations prohibiting conflicting outside employment. The requirement to obtain prior approval for outside employment has not identified any conflicts or otherwise enhanced the ethics program.

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,[1] 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[2] 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.[3] The rules do not contain any new collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended.[4]

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 that end, the ethical standards contained in the rules enacted today require the Commission's members and employees

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[1] 5 U.S.C. 553(b)(3)(A).
[2] 5 U.S.C. 601 *et seq.*
[3] 5 U.S.C. 804(3)(C).
[4] 44 U.S.C. 3501 *et seq.*

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 and Text of the Rule

This amendment to the Commission's ethics rules is 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 SEC.

For the reasons set out in the preamble, Title 5, Chapter XXXIV of the Code of Federal Regulations is amended as follows:

PART 4401—SUPPLEMENTAL STANDARDS OF ETHICAL CONDUCT FOR MEMBERS AND EMPLOYEES OF THE SECURITIES AND EXCHANGE COMMISSION

1. The authority citation for Part 4401 continues to read as follows:

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.

* * * * *

2. Section 4401.103 is amended by:

a. Removing and reserving paragraph (c)(1)(ii);

b. Revising paragraph (c)(1)(iii);

c. Removing paragraph (d); and

d. Redesignating paragraph (e) as paragraph (d).

The revision reads as follows:

§ 4401.103 Outside employment and activities.

* * * * *

(c) ***

(1) ***

(iii) No employee shall undertake the following types 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;

(C) Employment otherwise involved with the securities industry; or

(D) Employment otherwise in violation of any applicable law, rule or regulation.

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By the Commission.

Elizabeth M. Murphy
Secretary

Robert I. Cusick
Director, Office of Government Ethics

Dated: April 4, 2011

Commissioner Aguilar
Commissioner Paredes
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3184 / April 4, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29622 / April 4, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of

SCOTT E. DeSANO,
THOMAS H. BRUDERMAN,
TIMOTHY J. BURNIEIKA,
ROBERT L. BURNS,
DAVID K. DONOVAN,
EDWARD S. DRISCOLL,
JEFFREY D. HARRIS,
CHRISTOPHER J. HORAN,
STEVEN P. PASCUCCI and
KIRK C. SMITH,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 203(f) and 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO THOMAS H. BRUDERMAN

I.

On March 5, 2008, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Scott E. DeSano, Thomas H. Bruderman ("Bruderman" or "Respondent Bruderman"), Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith.

II.

In response to these proceedings, Respondent Bruderman 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 Bruderman consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Thomas H. Bruderman ("Order"), as set forth below.

III.

On the basis of this Order and Respondent Bruderman's Offer, the Commission finds[1] that:

Settling Respondent

1. **Thomas H. Bruderman** ("Bruderman"), age 42, lives in Boston, Massachusetts. He was an equity trader at FMR Co., Inc. from 1998 until his resignation in December 2004. At all relevant times, he was a sector trader specializing in healthcare and pharmaceuticals stocks.

Other Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is a privately-held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly-owned subsidiary of FMR LLC, a privately held Delaware corporation. FMR is an adviser to various institutional clients and has approximately $1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co., Inc.** is a privately-held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co., Inc. is a wholly-owned subsidiary of FMR (collectively "Fidelity") and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.[2]

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[1] The findings herein are made pursuant to Respondent Bruderman's Offer and are not binding on any other person or entity in this or any other proceeding.

[2] On March 5, 2008 and October 30, 2008, the Commission instituted related administrative and/or cease-and-desist proceedings against Fidelity, Lazard Capital Markets LLC, and certain of their employees. *See In the Matter of Fidelity Management & Research Co. and FMR Co. Inc.*, Advisers Act Release No. 2713, Admin. Proc. File No. 3-19276 (March 5, 2008); *In the Matter of Peter S. Lynch*, Company Act Release No. 28189, Admin. Proc. File No. 3-12980 (March 5, 2008); *In the Matter of Bart A. Grenier*, Advisers Act Release No. 2714, Admin. Proc. File No. 3-12977 (March 5, 2008); *In the Matter of Marc C. Beran*, Advisers Act Release No. 2716, Admin. Proc. File No. 3-12979 (March 5, 2008); *In the Matter of Lazard Capital Markets LLC*, Exchange Act Release No. 58880, Admin. Proc. File No. 3-13281 (October 30, 2008); *In the Matter of David L. Tashjian*, Exchange Act Release No. 58883, Admin. Proc. File No. 3-13284 (October 30, 2008); *In the Matter of Louis Gregory Rice*, Exchange Act Release No. 58881, Admin. Proc. File No. 3-13282 (October 30, 2008); *In the Matter of Robert A. Ward*, Exchange Act Release

Summary

4. These proceedings concern Bruderman's acceptance of travel and gifts from securities brokerage firms ("brokerage firms") with which he, through Fidelity, conducted business on behalf of Fidelity's clients, including the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Bruderman accepted a significant amount of travel and gifts from representatives of brokerage firms, including private airfare and extensive entertainment at his extravagant bachelor party in Miami, travel by private jet on numerous other trips and various expensive gifts. By accepting the travel and gifts, Bruderman willfully[3] violated Section 17(e)(1) of the Investment Company Act.

5. In addition, Bruderman failed to inform any manager at Fidelity that, during the Relevant Period, he received drugs from brokers doing business with Fidelity. Fidelity failed to disclose to its clients the material conflicts of interest arising from this conduct. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and Bruderman was a cause of Fidelity's violation of Section 206(2) of the Advisers Act.

Background

6. During the Relevant Period, Bruderman worked as a sector trader on Fidelity's equity trading desk and was an affiliated person of FMR Co., Inc., which is an affiliated person of registered investment companies (the Fidelity Funds). Fidelity's advisory clients (including the Fidelity Funds) gave Fidelity authority to select brokerage firms to execute securities transactions in their managed accounts. Portfolio managers initiated securities trades by contacting Fidelity's equity trading desk with orders to purchase or sell securities for client accounts under their management. As a Fidelity trader, Bruderman was responsible for, among other things, selecting brokerage firm(s) from a list of brokerage firms approved by Fidelity to execute securities transactions to fulfill the portfolio managers' orders.

Bruderman Accepted Travel and Gifts from Brokerage Firms

7. Bruderman received a significant amount of travel and gifts from representatives of brokerage firms during the Relevant Period. His bachelor party in Miami, Florida in March 2003 provides examples. Bruderman solicited certain brokers to arrange and

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No. 58882, Admin. Proc. File No. 3-13283 (October 30, 2008); and *In the Matter of W. Daniel Williams*, Exchange Act Release No. 58884, Admin. Proc. File No. 3-13285 (October 30, 2008).

[3] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

pay for events associated with it, and the brokers complied, paying for private jet travel, luxury accommodations at the Delano Hotel, a chartered yacht, golf, a limousine, expensive dinners, adult entertainment and the drug commonly referred to as "ecstacy." In addition to events associated with his bachelor party and other wedding-related expenses, brokers paid all or part of Bruderman's share of numerous other trips, most of which included private jet travel, lodging and entertainment. The trips were to such destinations as the Super Bowl (twice), the Caribbean, and Cabo San Lucas, Mexico. On many of the trips, brokers were not present and simply provided Bruderman and/or his fiancée (later wife) with the use of a private jet. These included trips to Puerto Rico, Florida, and his honeymoon in Los Angeles. Brokers also provided Bruderman with other gifts such as entry to a racing school, thousands of dollars worth of wine, a humidor with cigars, limousine service and numerous tickets to events that he did not attend with the broker.

Bruderman Violated Section 17(e)(1) of the Investment Company Act

8. As a result of the conduct described above, Bruderman willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. A violation of Section 17(e)(1) is complete upon receipt of the compensation. Bruderman was an affiliated person of Fidelity, which is an affiliated person of investment companies (the Fidelity Funds), because Fidelity advises those funds. Bruderman's receipt of travel and gifts from representatives of brokerage firms constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

Bruderman's Receipt of Drugs from Brokers

9. On a number of occasions, representatives of brokerage firms doing business with Fidelity provided Bruderman with the drug commonly referred to as "ecstacy." Bruderman failed to inform any Fidelity manager of that conduct.

Bruderman was a Cause of Fidelity's Violations of Section 206(2) of the Advisers Act for Failing to Disclose Certain Conflicts of Interest

10. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its clients, including the Fidelity Funds, the material conflicts of interest arising from Bruderman's receipt of drugs from brokers. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and Bruderman was a cause of Fidelity's violation of Section 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 Bruderman's Offer.

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

A. Respondent Bruderman cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act and Section 206(2) of the Advisers Act;

B. Respondent Bruderman be, and hereby is, censured; and

C. Respondent Bruderman shall, within ten days of the entry of this Order, pay disgorgement of $205,000, prejudgment interest of $74,218.18 and a civil money penalty in the amount of $70,000 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: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the Securities and Exchange Commission; (3) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312, Stop 0-3; and (4) submitted under cover letter that identifies Bruderman as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Securities and Exchange Commission, 33 Arch St., 23rd Floor, Boston, MA 02110.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
April 4, 2011

In the Matter of **Circuit Systems, Inc., Global Energy Group, Inc., Integrated Medical Resources, Inc., iNTELEFILM Corp., and Lot$off Corp.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

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

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Integrated Medical Resources, Inc. because it has not filed any periodic reports since the period ended September 30, 1998.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of iNTELEFILM Corp. because it has not filed any periodic reports since the period ended March 31, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Lot$off Corp. because it has not filed any periodic reports since the period ended October 30, 1998.

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 April 4, 2011, through 11:59 p.m. EDT on April 15, 2011.

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

April 5, 2011

In the Matter of Sabratek Corp., SAN Holdings, Inc., SBD International, Inc. (n/k/a Solargy Systems, Inc.), Scantek Medical, Inc., SciLabs Holdings, Inc., The SCO Group, Inc., Secure Technologies Group, Inc., Secured Digital Applications, Inc., Senco Sensors, Inc., Sentex Sensing Technology, Inc., Serefex Corp., SinoFresh HealthCare, Inc. Sonoma College, Inc., and Source Petroleum 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 Sabratek Corp. because it has not filed any periodic reports since the period ended March 31, 1999.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of SAN 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 SBD International, Inc.

(n/k/a Solargy Systems, Inc.) because it has not filed any periodic reports since the period ended September 30, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Scantek Medical, Inc. because it has not filed any periodic reports since the period ended March 31, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of SciLabs Holdings, Inc. because it has not filed any periodic reports since the period ended March 31, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of The SCO Group, Inc. because it has not filed any periodic reports since the period ended January 31, 2009.

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

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Senco Sensors, Inc. because it has not filed any periodic reports since the period ended November 30, 1999.

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

Technology, Inc. because it has not filed any periodic reports since the period ended August 31, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Serefex Corp. because it has not filed any periodic reports since the period ended February 28, 2009.

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

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Source Petroleum Inc. because it has not filed any periodic reports since the period ended June 30, 2007.

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 April 5, 2011, through 11:59 p.m. EDT on April 18, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64177 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14318

In the Matter of Sabratek Corp., SAN Holdings, Inc., SBD International, Inc. (n/k/a Solargy Systems, Inc.), Scantek Medical, Inc., SciLabs Holdings, Inc., The SCO Group, Inc., Secure Technologies Group, Inc., and SinoFresh HealthCare, 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 Sabratek Corp., SAN Holdings, Inc., SBD International, Inc. (n/k/a Solargy Systems, Inc.), Scantek Medical, Inc., SciLabs Holdings, Inc., The SCO Group, Inc., Secure Technologies Group, Inc., and SinoFresh HealthCare, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Sabratek Corp. (CIK No. 1012480) is a forfeited Delaware corporation located in Skokie, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sabratek is delinquent in its periodic filings with the

Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1999. On December 17, 1999, Sabratek filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, and the case was terminated on April 5, 2005. As of March 28, 2011, the company's common stock (symbol "SBTKQ") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had two market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. SAN Holdings, Inc. (CIK No. 799097) is a Colorado corporation located in Englewood, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SAN Holdings 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, 2007, which reported a net loss of $8 million for the prior six months. On November 26, 2007, SAN Holdings filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Colorado, and the case was still pending as of April 4, 2011. As of March 28, 2011, the company's stock (symbol "SNZH") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. SBD International, Inc. (n/k/a Solargy Systems, Inc.) (CIK No. 1106643) is a revoked Nevada corporation located in Fort Lauderdale, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SBD International is delinquent in its periodic filings with the Commission, having not filed any periodic reports that were compliant with requirements under the securities laws since it filed a Form 10-Q for the period ended September 30, 2006, which reported a loss of over $1.4 million for the prior nine months. Since that filing, SBD International has filed four Forms 10-Q for the periods ended June 30, 2008, June 30, 2009, June 30, 2010, and September 30, 2010, none of which were reviewed by an independent public accountant as required by Rule 10-01 of Regulation S-X. SBD International also filed Forms 10-K for the periods ended December 31, 2006 and December 31, 2007, but neither filing included audited financials as required by Rule 3-01, *et seq.*, of Regulation S-X. As of March 28, 2011, the company's stock (symbol "SLGS") was quoted on OTC Link and traded on the over-the-counter markets, had eleven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Scantek Medical, Inc. (CIK No. 926229) is a void Delaware corporation located in Mountain Lakes, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Scantek Medical 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, 2003, which reported a net loss of over $1.5 million for the prior nine months. On December 24, 2008, Scantek filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of New Jersey, and the case was still pending as of April 4, 2011. As of March 28, 2011, the company's stock (symbol "SKMLQ") was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. SciLabs Holdings, Inc. (CIK No. 1126936) is a void Delaware corporation located in Los Angeles, California with a class of securities registered with the

Commission pursuant to Exchange Act Section 12(g). SciLabs Holdings 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 over $339,000 for the prior three months. As of March 28, 2011, the company's stock (symbol "SILH") was quoted on OTC Link, had two market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. The SCO Group, Inc. (CIK No. 1102542) is a Delaware corporation located in Lindon, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). The SCO Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended January 31, 2009, which reported a net loss of $459,000 for the prior three months. On September 14, 2007, The SCO Group filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, and the case was still pending as of April 4, 2011. As of March 28, 2011, the company's stock (symbol "SCOXQ") was quoted on OTC Link, had fourteen market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

7. Secure Technologies Group, Inc. (CIK No. 316618) is a void Delaware corporation located in Boca Raton, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Secure Technologies is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2004, which reported a net loss of over $5.2 million for the prior twelve months. As of March 28, 2011, the company's stock (symbol "SCTC") was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

8. SinoFresh HealthCare, Inc. (CIK No. 1171596) is a Florida corporation located in Venice, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SinoFresh HealthCare is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB/A for the period ended September 30, 2008, which reported a net loss of over $1 million for the prior nine months. On November 1, 2010, SinoFresh HealthCare filed a Form 15, attempting to terminate its Section 12(g) registration and suspend its reporting obligations, but it was ineligible for deregistration. On February 16, 2011, SinoFresh HealthCare, accordingly, withdrew its Form 15. As of March 28, 2011, the company's stock (symbol "SFSH") was quoted on OTC Link, had twelve market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

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

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 hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

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

IV.

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

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

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64178 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14319

In the Matter of **Secured Digital Applications, Inc.,** **Senco Sensors, Inc.,** **Sentex Sensing Technology, Inc.,** **Serefex Corp.,** **Sonoma College, Inc., and** **Source Petroleum, 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 Secured Digital Applications, Inc., Senco Sensors, Inc., Sentex Sensing Technology, Inc., Serefex Corp., Sonoma College, Inc., and Source Petroleum, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Secured Digital Applications, Inc. (CIK No. 940516) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Secured Digital Applications is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q/A for the period ended September 30, 2008. As of March 28, 2011, the company's stock (symbol "SDGL") was quoted on OTC Link, had

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

2. Senco Sensors, Inc. (CIK No. 1069809) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Senco Sensors is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended November 30, 1999, which reported a net loss of over $2.7 million (Canadian) for the prior twelve months. As of March 28, 2011, the company's stock (symbol "SNCOF") was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Sentex Sensing Technology, Inc. (CIK No. 729599) is a New Jersey corporation located in Cleveland, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sentex Sensing Technology is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended August 31, 2007, which reported a net loss of over $2.3 million for the prior nine months. As of March 28, 2011, the company's stock (symbol "SNTX") was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Serefex Corp. (CIK No. 773937) is a Delaware corporation located in Hudson, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Serefex 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 February 28, 2009, which reported a net loss of over $185,000 for the prior nine months. As of March 28, 2011, the company's stock (symbol "SFXC") was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Sonoma College, Inc. (CIK No. 1308930) is a suspended California corporation located in Petaluma, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sonoma College 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, 2006, which reported a net loss of over $897,000 for the prior three months. As of March 28, 2011, the company's stock (symbol "SNMA") was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. Source Petroleum Inc. (CIK No. 1314363) is a revoked Nevada corporation located in Calgary, Alberta, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Source Petroleum 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, 2007, which reported a net loss of over $420,000 for the prior six months. On May 5, 2006, Source Petroleum filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Western District of Louisiana, and the case was terminated on September 11, 2007. As of March 28, 2011, the

company's stock (symbol "SOPO") was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

7. 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.

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

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

III.

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

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

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

IV.

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

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

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9201 / April 5, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64183 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14320

In the Matter of

Wells Fargo Securities LLC (f/k/a Wachovia Capital Markets LLC)

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 WELLS FARGO SECURITIES AND ITS AFFILIATES

Wells Fargo Securities LLC ("Wells Fargo") has submitted a letter on behalf of itself and its affiliates, dated December 29, 2010, for a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 (the "Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 (the "Exchange Act") arising from its settlement of an administrative proceeding brought by the Commission.

On April 5, 2011, the Commission instituted administrative and cease-and-desist proceedings against Wells Fargo, a registered broker-dealer. In the order instituting proceedings, the Commission found that Wells Fargo 1) charged undisclosed excessive markups in the sale of the preferred shares of a collateralized debt obligation ("CDO"); and 2) made false and misleading representations in the offering circular of another CDO. Based on these allegations, the Commission concluded that Wells Fargo violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. Without admitting or denying the findings, Wells Fargo consented to the entry of an order requiring it to cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and (3) of the Securities Act (the "Order").

The safe harbor provisions of Section 27(A)(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 . . . (II) requires that the issuer cease and desist from violating 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 Wells Fargo's letter, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the issuance of the Commission's Order 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 Wells Fargo and its affiliates resulting from the entry of the Order is hereby granted.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro, Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9200 / April 5, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64182 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14320

In the Matter of **Wells Fargo Securities LLC (f/k/a Wachovia Capital Markets LLC)** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Wells Fargo Securities LLC (f/k/a Wachovia Capital Markets LLC) ("Respondent" or "Wells Fargo Securities").

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 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

1. These proceedings concern two collateralized debt obligations ("CDOs") tied to the performance of residential mortgage-backed securities ("RMBS"), Grand Avenue CDO II ("Grand Avenue II") and Longshore CDO Funding 2007-3 ("Longshore 3"). Wachovia Capital Markets LLC ("Wachovia Capital Markets") structured and marketed these two RMBS CDOs in late 2006 and early 2007 when the United States housing market was beginning to show signs of distress.

2. In so doing Wachovia Capital Markets violated the antifraud provisions of the Securities Act in two respects. First, Wachovia Capital Markets charged undisclosed excessive markups in the sale of certain of the preferred shares, or equity, of Grand Avenue II to the Pueblo of Zuni and the Pension Plan and Trust for Employees of the Pueblo of Zuni (collectively the "Zuni Indian Tribe") and an individual investor. Second, Wachovia Capital Markets represented to investors in Longshore 3 that it acquired assets from affiliates "on an arm's-length basis" and "at fair market prices" when in fact certain assets were transferred from an affiliate at above-market prices.

Respondent

3. Wachovia Capital Markets was a registered broker-dealer and wholly-owned subsidiary of Wachovia Corporation during the relevant period. Wachovia Capital Markets conducted the corporate and investment banking business of Wachovia Corporation's securities business. Wachovia Capital Markets was renamed Wells Fargo Securities, LLC after Wachovia Corporation merged with Wells Fargo & Company on December 31, 2008. Wachovia Capital Markets structured and marketed Grand Avenue II and Longshore 3.

Other Relevant Entity

4. Wachovia Securities LLC ("Wachovia Securities") was a registered broker-dealer and wholly-owned subsidiary of Wachovia Corporation during the relevant period. Wachovia Securities conducted the retail brokerage business of Wachovia Corporation's securities business. Wachovia Securities was renamed Wells Fargo Advisors LLC after Wachovia Corporation merged with Wells Fargo & Company on December 31, 2008. Wachovia Securities was involved in the sale of the Grand Avenue II preferred shares.

Grand Avenue II

RMBS CDO Equity Generally

5. RMBS CDO equity is a complex, highly-leveraged structured product. RMBS are securities backed by residential mortgages. Investors receive payments out of the interest and principal payments from the underlying mortgages. RMBS CDOs are collateralized by RMBS. The RMBS are packaged and generally held by a special purpose vehicle that issues notes entitling the holders to payments derived from the underlying RMBS. The notes issued by RMBS CDOs are securities with defined risk profiles determined by a hierarchical, tranched structure. The cash flows from the RMBS are divided according to defined rights among the tranches of the CDO in a waterfall fashion.

6. The AAA-rated tranches are at the top of the waterfall with the first right to receive principal and interest if there is a shortfall. As a result, they have the highest credit quality, meaning the lowest likelihood of being affected by problems in the underlying collateral. The lower tranches are junior in priority and therefore more risky. The equity tranche is at the bottom of the capital structure and the most risky, but has the potential for the highest payout. Equity investors are generally the first to experience losses associated with a deterioration of the underlying mortgage loan portfolio.

Sale of Grand Avenue II Preferred Shares

7. Grand Avenue II was a $1.5 billion CDO backed by a portfolio of RMBS. The deal closed on October 26, 2006. At closing, Wachovia Capital Markets had been unable to sell $5.5 million of preferred shares, or equity, in the transaction. Wachovia Capital Markets retained those securities in its CDO syndicate desk's inventory and marked them at 52.7 on the company's books and records for purposes of financial reporting in accordance with generally accepted accounting principles ("GAAP") (preferred share prices referenced herein are represented as percentages of par).[1] GAAP required that Wachovia Capital Markets value the securities at an estimate of the price at which they could be sold in the market in a reasonably short period of time.

8. Wachovia sold the securities in February and March 2007 to the Zuni Indian Tribe and an individual investor. Both were customers of a Wachovia Securities registered representative located in El Paso, Texas. The Zuni Indian Tribe and the individual investor paid 90 and 95 as detailed below. Unbeknownst to them, this represented a markup of over 70 percent above the price at which the preferred shares were marked on Wachovia Capital Markets' books, which was 52.7. By the end of 2007, the RMBS held (or referenced) by Grand Avenue II had been downgraded substantially and the transaction went into default as of February 1, 2008.

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[1] CDO equity is not listed on a U.S. exchange and trades infrequently and thus current prices are not readily discoverable. CDO equity is generally valued using models whose varying inputs produce a range of prices.

9. The mechanics by which the Grand Avenue II preferred shares were sold were as follows. On or about February 13, 2007, Wachovia Capital Markets sold $2 million of the Grand Avenue II preferred shares to Wachovia Securities at 90.5, and then on February 14, 2007, Wachovia Securities sold those securities to the Zuni Indian Tribe at 95. On or about March 12, 2007, Wachovia Capital Markets sold another $2 million of the Grand Avenue II preferred shares to Wachovia Securities at 85.5. On March 15, 2007, Wachovia Securities sold $890,000 of these securities to the Zuni Indian Tribe and $1,110,000 to the individual investor at 90. On or about March 16, 2007, Wachovia Capital Markets sold $1.5 million of the Grand Avenue II preferred shares to Wachovia Securities at 85.5, and then on March 20, 2007, Wachovia Securities sold those securities to the individual investor at 90.

Wachovia Did Not Surveil for Markups on the CDO Syndicate Desk

10. The prices at which the Grand Avenue II preferred shares were sold to Wachovia Securities were determined by Wachovia Capital Markets. Wachovia Securities then determined the ultimate price to investors.

11. At the time of the sales of the Grand Avenue II preferred shares to Wachovia Securities, the shares were held in the inventory of the Wachovia Capital Markets' CDO syndicate desk. The CDO syndicate desk was typically involved in primary sales of securities at par or other prices negotiated with the investor, so a markup calculation was inapplicable. As a result, Wachovia Capital Markets' compliance department did not surveil markups on positions sold off of the CDO syndicate desk during the relevant period.

12. Wachovia Securities' compliance department approved the sales of the Grand Avenue II preferred shares to the Zuni Indian Tribe and the individual investor. Wachovia Securities did so with the understanding that it was marking up the securities approximately five percent from 90.5 to 95 and from 85.5 to 90. Wachovia Securities' compliance personnel were not aware that Wachovia Capital Markets had marked the securities at 52.7 and that, as a result, the ultimate markup to investors was over 70 percent.

13. Wachovia Capital Markets' CDO secondary trading desk made a market in CDOs and engaged in secondary trading thereof. The compliance department at Wachovia Capital Markets surveilled markups on the CDO secondary trading desk and flagged for review any sale at a price in excess of five percent from certain defined references; however, there was no surveillance of markups of positions sold off of the CDO syndicate desk because the CDO syndicate desk typically engaged in the primary sales of securities.

Undisclosed Excessive Markups

14. Under the so-called "shingle theory," a broker-dealer violates the antifraud provisions of the federal securities laws by charging customers excessive undisclosed markups. Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 189-94 (2d Cir. 1998). A markup is the difference between the price charged the customer and the prevailing market price. Id. at 189. A markup is excessive if it bears no reasonable relation to the prevailing market price. Id. at 190.

Negligence-based violations of Sections 17(a)(2) and (3) are appropriate where a broker-dealer should have known that the prices it charged were excessive. See, e.g. In the Matter of Mark David Anderson, Admin. Proc. File No. 3-9494, 2003 SEC LEXIS 1935 (2003); In the Matter of Marion Bass Securities Corp., Admin. Proc. File No. 3-9471, 2000 SEC LEXIS 2806 (2000); In the Matter of BT Alex Brown Incorporated, Admin. Proc. File No. 3-10097, 1999 SEC LEXIS 2443 (1999).

15. Wachovia Capital Markets charged undisclosed excessive markups in the sale of the Grand Avenue II preferred shares to Wachovia Securities for subsequent sale to the Zuni Indian Tribe and an individual investor. These investors paid 90 and 95. Unbeknownst to the investors or Wachovia Securities, this represented a markup of over 70 percent above Wachovia Capital Markets' internal mark on the Grand Avenue II preferred shares, which was 52.7. In so doing, Wachovia Capital Markets violated Sections 17(a)(2) and (3) of the Securities Act under the shingle theory because it knew or should have known that the prices it charged were excessive.

16. As a result of the negligent conduct described above, Wachovia Capital Markets willfully[2] violated Sections 17(a)(2) and (3) of the Securities Act, which prohibit fraudulent conduct in the offer and sale of securities.

Longshore 3

CDO Warehousing Process In The Industry Generally

17. Prior to the closing date of a CDO, it is typical for the structurer (or an affiliate of the structurer) to finance the acquisition of CDO collateral, which is often selected on the advice of the collateral manager. This pre-closing process is called "warehousing." During the warehouse phase, the collateral is consolidated on the balance sheet of the structurer, or its affiliate providing the financing. On the closing date, the CDO pays the structurer – either to buy the collateral or to repay the structurer for financing the collateral – by using the proceeds from the sale of notes to investors.

18. Prior to the closing, the CDO structurer or an affiliate bears "warehouse risk," meaning that the collateral will remain with the entity that provided the warehouse in the event the deal fails to close or is downsized and the CDO fails to purchase the collateral from the CDO structurer or its affiliate. Warehouse risk is one of the principal risks associated with the CDO structuring business. A number of large financial institutions suffered significant losses on RMBS and other debt obligations in their CDO warehouses during the recent financial crisis.

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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)).

Transfer Of Assets To Longshore 3 At Above-Market Prices

19. As of February 2007, Wachovia Capital Markets was in the process of warehousing collateral for two RMBS CDOs, Longshore 3 and another proposed CDO (the "Transferor Warehouse"). Longshore 3 was a $1.3 billion CDO backed by a portfolio of RMBS and other asset-backed securities. The deal closed on April 26, 2007. Wachovia Capital Markets decided not to proceed with the other CDO due to market conditions. Wachovia Capital Markets as CDO structurer was then faced with the prospect of suffering losses on a portfolio of cash and synthetic[3] RMBS that had accumulated in the Transferor Warehouse.

20. Wachovia Capital Markets avoided losses on some of these assets by transferring 40 RMBS (28 cash and 12 synthetic) with a total notional value of approximately $250 million from the Transferor Warehouse to the warehouse for Longshore 3 at the prices at which the assets had originally been acquired (the "acquisition cost"). That acquisition cost was approximately $4.6 million above the market prices at the time of the transfer because the market had moved in the period between the original acquisition of the assets and the time of the transfer.

21. Structured Asset Investors LLC ("SAI"), a wholly-owned subsidiary of Wachovia Corporation during the relevant period, was the collateral manager for Longshore 3. SAI personnel responsible for managing collateral for RMBS CDOs wanted to ensure that Longshore 3 acquired assets at appropriate prices and raised questions regarding the acquisition of collateral for Longshore 3 at acquisition cost given changes in the market for such collateral. The issue was brought before the ABS CDO Investment Management Committee (the "IMC"), which was responsible for managing conflicts of interest between SAI and Wachovia Capital Markets. At a meeting on or about March 16, 2007, the IMC approved the transfer of assets at their acquisition costs on the condition that Wachovia Capital Markets make certain disclosures to investors relating to the pricing issue. The IMC directed SAI to select from the Transferor Warehouse only those RMBS it deemed acceptable for Longshore 3, and SAI did so.

22. Wachovia Capital Markets made two sets of disclosures relating to the pricing issue (SAI was not involved in the disclosure process). First, Wachovia Capital Markets provided prospective investors in Longshore 3 spreadsheets with identical "purchase" and "transfer" prices for every asset in the portfolio prior to the pricing of the transaction (investors generally commit to purchase CDO securities at pricing). Wachovia Capital Markets emailed the spreadsheet to six (6) of the seven (7) investors in Longshore 3; the seventh investor received a spreadsheet identifying all of the assets in the portfolio and their "purchase" prices. Those spreadsheets failed to specifically indicate that a portion of the collateral was previously acquired

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[3] CDOs sometimes assume credit risk by entering into credit default swaps referencing RMBS, referred to in the documentation as "synthetic" securities, rather than by purchasing the RMBS. The CDO described herein assumed a relatively small amount of risk in this manner; however, this alternative form of assuming RMBS exposure does not change the analysis. Thus, for reasons of convenience, the analysis herein does not further discuss the concept of credit default swaps referencing RMBS.

for the Transferor Warehouse at then-current market prices and then transferred to the warehouse for Longshore 3 from an affiliate of SAI at their acquisition costs, which no longer represented market prices.

23. Second, Wachovia Capital Markets represented in the Offering Circular for Longshore 3 that collateral acquired from affiliates of SAI would be acquired in transactions "on an arm's-length basis" and "at fair market prices" representative of transactions entered into (the "Affiliate Transaction Disclosures"). Those representations were false and misleading because assets transferred from the Transferor Warehouse were priced approximately $4.6 million above their then-current market prices as determined by Wachovia Capital Markets' internal marks on the assets. Wachovia Capital Markets provided similar disclosure concerning the acquisition and pricing of assets in offering circulars for other CDOs. Wachovia Capital Markets attempted to modify the representations in the Offering Circular for Longshore 3 concerning the prices at which collateral was acquired into the Longshore 3 warehouse to address the decision by the IMC to allow Longshore 3 to buy collateral from the Transferor Warehouse at above-market prices, but the standard Affiliate Transaction Disclosures in the Offering Circular were not modified to address the decision by the IMC to allow Longshore 3 to buy collateral from the Transferor Warehouse at above-market prices. Wachovia Capital Markets provided copies of the Offering Circular to all seven (7) investors in Longshore 3.

Disclosure Violations

24. Section 17(a) of the Securities Act prohibits the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Violations of Sections 17(a)(2) and (3) may be established by showing negligence. SEC v. Hughes Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992). Negligence-based violations of Sections 17(a)(2) and (3) are appropriate where material misrepresentations or omissions resulted from a lack of disclosure training and inadequate procedures relating to the drafting and review of offering documents. In the Matter of State of New Jersey, Admin. Proc. File No. 3-14009, 2010 SEC LEXIS 2705 at *39 (2010).

25. Wachovia Capital Markets represented to investors in Longshore 3 that it acquired assets from affiliates of SAI "on an arm's-length basis" and "at fair market prices." Those representations were false and misleading because approximately $250 million worth of RMBS were transferred from an affiliate at prices approximately $4.6 million above the market value at the time of the transfer into the Longshore 3 warehouse. SAI personnel responsible for managing collateral for RMBS CDOs believed it would have affected an investor's negotiation of their purchase price of the CDO if they had known that certain assets were being transferred into the Longshore 3 warehouse at acquisition cost rather than current market price. Wachovia Capital Markets acted negligently in at least two respects. First, Wachovia Capital Markets attempted, albeit unsuccessfully, to disclose the issue by providing prospective investors spreadsheets with

certain pricing data. Second, the standard Affiliate Transaction Disclosures in the Offering Circular were not modified to address these circumstances. In both instances, Wachovia Capital Markets exercised inadequate care in making the pricing disclosures.

26. As a result of the negligent conduct described above, Wachovia Capital willfully (see footnote 2 supra) violated Sections 17(a)(2) and (3) of the Securities Act which prohibit fraudulent conduct in the offer and sale of securities.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent Wells Fargo Securities and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in the Offer of Wells Fargo Securities.

Accordingly, pursuant to Section 8A of the Securities Act and Section 15(b) of the Exchange Act, it is hereby ORDERED that:

A. Respondent Wells Fargo Securities cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act.

B. Respondent Wells Fargo Securities shall, within 10 days of the entry of this Order, pay disgorgement of $6.75 million and a civil money penalty in the amount of $4.45 million. Respondent shall satisfy this obligation by (i) disbursing $7.4 million pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002 as distribution of losses: Respondent shall make $1.319 million in payment(s) to and for the benefit of the Zuni Indian Tribe; Respondent shall make a $1.064 million payment to and for the benefit of the individual investor who purchased the preferred shares in Grand Avenue II; and Respondent shall make $5.017 million in payment(s) to and for the benefit of the investors acquiring Longshore 3 securities from the initial purchaser (Wachovia Capital Markets) on the closing date of Longshore 3, pro rata based on their original investment; and (ii) making a payment of $3.8 million to the Securities and Exchange Commission, Office of Financial Management, Operations Center, 6432 General Green Way, Mail Stop 0-3, Alexandria, Virginia 22312. Payments shall be accompanied with a notification that identifies Wells Fargo Securities as the Respondent in these proceedings. Respondent shall simultaneously transmit a copy of such payment and notification to Reid A. Muoio, Deputy Chief, Structured and New Products Unit, Division of Enforcement, 100 F Street N.E., Washington, DC 20549-5030. Respondent will cooperate with the staff of the Commission to obtain evidence of receipt of the payments set forth herein.

C. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund is created for the disgorgement and penalties referenced in paragraph B above.

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. 64184 / April 5, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3257 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14321

In the Matter of	ORDER INSTITUTING PUBLIC 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
Lovelock & Lewes, Price Waterhouse, Bangalore, Price Waterhouse & Co., Bangalore, Price Waterhouse, Calcutta, and Price Waterhouse & Co., Calcutta,	
Respondents.	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against Lovelock & Lewes ("Lovelock"), Price Waterhouse, Bangalore ("PW Bangalore"), Price Waterhouse & Co., Bangalore ("PW Co. Bangalore"), Price Waterhouse Calcutta ("PW Calcutta"), and Price Waterhouse & Co., Calcutta ("PW Co. Calcutta") (collectively "PW India," the "PW India Firms" or "Respondents") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934

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[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others; (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

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 Respondents and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Public 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 Respondents' Offer, the Commission finds[3] that:

A. SUMMARY

1. This matter involves violations of federal securities laws and improper professional conduct by PW India while PW Bangalore served as auditor of record for Satyam Computer Services Limited ("Satyam") from 2005 through January 2009. In connection with Satyam's 2005-2008 publicly-filed financial statements, Satyam engaged in fraudulent financial accounting by falsifying the company's revenue, income, earnings per share, cash, and interest bearing deposits. Satyam acknowledged that it falsely reported over $1 billion in revenue and cash, among other items, in its publicly filed financial statements. In January 2009, Satyam submitted a Form 6-K with the Commission indicating that "Price Waterhouse's audit reports and opinions in relation to Satyam's financial statements from the quarter ended June 30, 2000 until the quarter ended September 30, 2008 should no longer be relied upon."

2. Former officers and senior managers at Satyam, an Indian information technology service company with depository shares traded on the New York Stock Exchange ("NYSE") during the relevant period, directed the creation of over 6,000 false invoices that they ensured were entered into the company's general ledger and falsely recorded as, among other things, revenue, income, and accounts receivable in Satyam's publicly filed financial statements. Former senior management at Satyam manufactured scores of false bank statements, confirmations, and supporting documents

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[2] Rule 102(e)(1)(ii) provides, in pertinent part, that: "[t]he Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct."

[3] 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.

to reflect payment of the false invoices and created over $1 billion in fictitious cash balances and other interest bearing deposits. This false information made Satyam appear to be substantially more profitable and financially sound than was actually the case. When the fraud was revealed, the price of Satyam's depository shares plummeted and institutional investors located in the United States sustained realized losses of over $450 million.

3. PW Bangalore issued unqualified opinions on Satyam's March 31, 2005, March 31, 2006, March 31, 2007, and March 31, 2008 financial statements. Each of these audit reports stated that "Price Waterhouse" conducted its audits in accordance with generally accepted auditing standards in the United States ("GAAS") and that Satyam's financial statements were presented in conformity with generally accepted accounting principles ("GAAP"). Each audit report also stated that the underlying audit was conducted in accordance with Public Company Accounting Oversight Board ("PCAOB") Standards. Contrary to the audit reports, PW India did not conduct Satyam's audits in accordance with PCAOB Standards, which is now understood to include GAAS.[4] Specifically, the PW India partners and staff on the Satyam engagement team ("Satyam engagement team" or "engagement team") failed to maintain control of the confirmation process with respect to cash and cash equivalent balances as well as Satyam's accounts receivables. The failure to properly execute third-party confirmation procedures resulted in the fraud at Satyam going undetected until the former chairman's public confession in January 2009.

4. The failures in the confirmation process on the Satyam audit were not limited to that engagement, but were indicative of a quality control failure throughout PW India. During the relevant period, PW India's quality control system failed to detect that engagement teams throughout PW India routinely relinquished control of the delivery and receipt of cash confirmations to their audit clients and rarely, if ever, questioned the integrity of the confirmation responses they received from the clients. Despite annual quality reviews, PW India did not recognize this compliance failure until after January 2009.

5. By failing to comply with PCAOB Standards, PW Bangalore issued audit reports in connection with the Satyam engagement that were not accurate and, as a result, the PW India Firms were a cause of Satyam's issuing materially false and misleading financial statements and its violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-16 thereunder. The PW India Firms also violated Section 10A(a) of the Exchange Act by failing to conduct procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.

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[4] References in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they related to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission. See Release Nos. 33-8422; 34-49708; FR-73 at http://www.sec.gov/rules/interp/33-8422.htm.

B. RESPONDENTS

6. Lovelock & Lewes ("Lovelock") is a public accounting firm organized as a partnership under the laws of the Republic of India, and headquartered in Kolkata, West Bengal, India.

7. Price Waterhouse, Bangalore ("PW Bangalore") is a public accounting firm organized as a partnership under the laws of the Republic of India, and headquartered in Bangalore, Karnataka, India.

8. Price Waterhouse & Co., Bangalore ("PW Co. Bangalore") is a public accounting firm organized as a partnership under the laws of the Republic of India, and headquartered in Bangalore, Karnataka, India.

9. Price Waterhouse & Co., Calcutta ("PW Co. Calcutta") is a public accounting firm organized as a partnership under the laws of the Republic of India, and headquartered in Kolkata, West Bengal, India.

10. Price Waterhouse, Calcutta ("PW Calcutta") is a public accounting firm organized as a partnership under the laws of the Republic of India, and headquartered in Kolkata, West Bengal, India.

11. Lovelock, PW Bangalore, PW Co. Bangalore, PW Co. Calcutta, and PW Calcutta are member firms of PricewaterhouseCoopers International Limited, a United Kingdom-based private company.[5] Respondents are registered in the United States with the PCAOB and in India with the Institute of Chartered Accountants of India ("ICAI"). Section 102 of the Sarbanes-Oxley Act of 2002 ("SOX") prohibits accounting firms that are not registered with the PCAOB from preparing or issuing audit reports on United States public companies and from participating in such audits. Section 106(a) of SOX further authorizes the PCAOB to require that non-US public accounting firms that do not issue such reports, but that play a substantial role in the preparation of the audit reports, register with the PCAOB.

12. PW India, along with five other India-based PwC Network Firms,[6] operate as a domestic Indian network of related audit firms. As such, these firms share common audit and other assurance and assurance risk management leadership and follow common audit and other assurance policies and procedures, including in the areas of audit and assurance risk management, training and supervision.

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[5] Member firms of PricewaterhouseCoopers International Limited ("PwC IL"), are collectively referred to herein as "PwC Network Firms."

[6] The five other India-based firms are registered with the ICAI but not with the PCAOB. They do not perform audit work for SEC registrants.

13. PW India and the five other India-based PwC Network Firms operate their audit practices under resource sharing arrangements that facilitate the provision of audit services as a network of related firms. With respect to the PW India Firms, pursuant to these arrangements, Lovelock and PW Calcutta have both partners and staff who perform audit procedures and provide staffing for their own audit engagements, as well as for engagements of the other PW India Firms. The partners of the remaining PW India Firms, PW Bangalore, PW Co. Bangalore, and PW Co. Calcutta, undertake audit engagements, oversee the audit work conducted by engagement personnel, and sign audit opinions. PW India partners typically are affiliated with several firms within the domestic network of audit firms simultaneously. During the relevant period, PW India and the other domestic India-based firms shared resources and settled inter-firm balances at the end of each fiscal year.

14. PW India and the five other India-based PwC Network Firms operate in a manner that generally does not make any distinctions among the individual firms in the network. For example, the PW India Firms share office space and have identical telephone numbers. In addition, the Respondents' website makes no obvious distinction among the individual PwC Network Firms located in India.

15. Satyam's Forms 20-F during the relevant period list the company's independent registered public accounting firm as "Price Waterhouse," the name of PW Bangalore set forth in its partnership deed. During the relevant period, the Satyam audit reports were signed by PW Bangalore engagement partners who were also partners at Lovelock.[7] Audit work on the Satyam engagement was performed predominately by partners and staff associated with these firms, although staff from PW Calcutta and partners of all five PW India firms billed time on the Satyam audits during the relevant period.

C. ISSUER

16. Satyam Computer Services Limited ("Satyam") is a large information technology service company incorporated in India with its principal executive offices in Hyderabad. Satyam's equity shares trade on the Bombay Stock Exchange and the National Stock Exchange of India. Satyam also has 65 million American Depository Shares ("ADS") representing approximately 11 percent of the company's equity shares. At all relevant times, Satyam's equity shares underlying the ADS were registered pursuant to Section 12(b) of the Exchange Act, and Satyam's ADS were listed on the NYSE. On October 4, 2010, Satyam filed a Form 25 with the Commission voluntarily removing its securities from listing on the NYSE and from registration under Section 12(b). Satyam's equity shares underlying the ADS are currently deemed registered pursuant to Section 12(g) of the Exchange Act, and Satyam's ADS are currently quoted on the OTC Market under the symbol SAYCY.PK.

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[7] The lead engagement partner for the audit of Satyam's fiscal year ended March 31, 2008 was also listed as a partner of PW Co. Calcutta.

17. Shortly after the fraud became public, the Government of India assumed control of the company. In mid-February 2009, the Company Law Board of India authorized the company to select a strategic investor for Satyam. As a result of the bidding process, Tech Mahindra Limited, an Indian information technology competitor, through its subsidiary Venturbay Consultants Private Limited, purchased approximately 42 percent of Satyam's shares in India and became the new controlling shareholder of Satyam. In June 2009, Satyam filed a press release announcing "Mahindra Satyam" as the company's new "brand identity." The company continues to conduct business in the United States as Satyam and is registered as a corporation doing business in the State of New York and as a foreign private issuer with the Commission under the name Satyam.

D. FACTS

18. In connection with fiscal years 2005 through 2008, as well as earlier years, Satyam engaged in certain practices relating to its revenue, income, cash, interest-bearing deposits, and accounts receivable that made its financial statements materially false and misleading. PW India's audits of Satyam's financial statements for fiscal years 2005 through 2008 were deficient. Among other things, PW India departed from applicable PCAOB Standards by failing to maintain control of the confirmation process with respect to cash, interest bearing deposits, and accounts receivable balances. As a result, PW India failed to uncover Satyam's fraud and, instead, issued unqualified audit opinions in connection with its audits of Satyam's financial statements until its former Chairman admitted that the company had been engaged in a billion dollar financial fraud and Satyam publicly disclosed that admission in a Form 6-K. As indicated herein, the failures PW India experienced on the Satyam audit were not limited to that engagement, but were indicative of a quality control failure throughout PW India.

Satyam's Accounting Fraud

19. Satyam falsified its reported revenue by manufacturing false invoices for services never provided and, in some cases, for customers that did not exist. From at least 2005 through 2008, Satyam's former senior management instructed certain employees to generate thousands of false invoices and record them in the company's invoice management system. The invoice management system exported the fake invoices into Satyam's financial system where the revenues were recorded in the company's general ledger. Based upon the fictitious invoices, Satyam materially overstated revenue and net income from at least fiscal year 2005 through the first two quarters of fiscal year 2009 by over $1 billion.

20. To support the false revenue and income that Satyam was reporting in its financial statements, Satyam prepared materially false bank statements, from at least fiscal year 2005 through 2008, reflecting materially false cash deposits in the company's bank accounts at, among other places, the Bank of Baroda ("BOB"), which were recorded within the cash and cash equivalent balances in Satyam's publicly-filed financial statements.

21. To make it appear that Satyam was investing its false income during the relevant time period, Satyam's former senior management manufactured scores of false bank statements and

also materially falsified the company's publicly filed financial statements with regard to the balance and fixed deposit receipts (hereinafter "interest bearing deposits") and corresponding interest income in accounts held at HSBC, BNP Paribas, HDFC, Citibank, and ICICI.

22. In Satyam's 2005, 2006, 2007, and 2008 financial statements, the company reported, among other assets, balance sheet line items entitled (a) "cash and cash equivalents," and (b) investments in bank deposits" (collectively, the "cash" line items). During these years, Satyam's cash line items represented the largest asset on its reported balance sheet, making up 50% or more of Satyam's total assets during the relevant period. For example, in 2008, Satyam reported cash of $1.1 billion, constituting approximately 50 percent of total reported assets. The vast majority of the cash purportedly was on deposit at BOB, HSBC, BNP Paribas, HDFC, Citibank, and ICICI.

23. On January 7, 2009, Satyam submitted a Form 6-K with the Commission that included a letter prepared by the then-Chairman of Satyam, B. Ramalinga Raju ("Raju"), admitting that the company had been engaged in a billion dollar fraud. According to Raju's letter, as of September 30, 2008, Satyam's balance sheet reflected over $1 billion in fictitious cash and bank balances when the actual amount was $66 million.

24. On January 14, 2009, Satyam submitted a Form 6-K with the Commission indicating that "Price Waterhouse" had advised that all audit reports and opinions in relation to Satyam's financial statements during the relevant period should no longer be relied upon.

25. On February 21, 2009, Satyam submitted a Form 6-K with the Commission indicating that Satyam's Board of Directors accepted the resignation of "Price Waterhouse" as Satyam's independent auditor.

26. The two PW India lead engagement partners for the Satyam audits during the relevant period are defendants, along with a significant number of former senior and mid-level executives of Satyam, including the former Chairman, the former Managing Director and Chief Executive Officer, and the former Chief Financial Officer, in a criminal trial in India arising out of the Satyam fraud. The trial is underway. The two PW India engagement partners have also been the subject of ongoing disciplinary matters in India before the ICAI and the Securities and Exchange Board of India involving their role in the Satyam audit. The two PW India lead partners and the two PW India senior managers who were the engagement managers on the Satyam audits during the relevant period were relieved of all auditing responsibilities in January 2009. The two engagement managers resigned in February 2010 and the lead engagement partner for the audits of Satyam's fiscal years ended March 1999-2007 retired in March 2009. The lead engagement partner for the audit of Satyam's fiscal year ended March 31, 2008 is on administrative leave from PW India pending the outcome of the various proceedings against him. On March 16, 2010, the two former PW India engagement managers were barred by the PCAOB from being associated persons of a registered public accounting firm for their failure to comply with a demand requiring their testimony in a PCAOB-related investigation into the Satyam audit engagements. These PW India managers are also the subject of ongoing disciplinary proceedings before the ICAI.

PW India's Audits of Cash and Cash Equivalent Balances
Were Not Performed in Accordance with PCAOB Standards
for Fiscal Years 2005-2008

27. Respondents failed to identify the material overstatement of Satyam's assets, in part, because the engagement team failed to carry out the confirmation processes and procedures related to cash and interest bearing deposits in accordance with PCAOB Standards -- and its own audit plan -- for fiscal years 2005-2008. PCAOB Standards require, among other things, that auditors test the existence and valuation of reported cash and interest bearing deposit balances. In order to test the cash and interest bearing deposit balances during the relevant period, the audit plans for each year during the relevant period called for the confirmation of Satyam's major bank balances and interest bearing deposits with third parties. The working papers for each year during the relevant period document that the engagement team confirmed cash balances and interest bearing deposits for all banks at which Satyam had "major" accounts.

28. Respondents failed to make direct contact with either BOB, the New York branch that held Satyam's purported largest bank account, or the five largest banks purportedly holding Satyam's interest bearing deposits to confirm the cash and cash equivalent balances that Satyam reported in its financial statements. Instead, and in violation of PCAOB Standards, the engagement team relied on the company's senior management to mail out confirmation requests to Satyam's banks, and on the purported responses to those letters from the banks, including purported responses provided to the engagement team by Satyam management. Respondents never attempted to contact the banks directly at any time during the audits.

29. Respondents also failed to conduct appropriate inquiry after receiving confirmations directly from banks that were potentially conflicting with those received from Satyam management. During the fiscal year 2005, 2006, 2007 and 2008 audits, the Satyam engagement team received confirmations, in the requested format, directly from branches of certain banks that purportedly held Satyam's largest interest bearing fixed deposit balances. The engagement team also received confirmations from Satyam's management that purported to confirm fixed deposit balances at a different branch of the same bank. The confirmations received from Satyam management were not in the format requested by the engagement team. The bank-provided confirmation responses reflected significantly lesser cash balances than Satyam management represented to be held in fixed deposits at the same banks, and significantly lesser cash balances than what was reflected in the purported bank confirmations that Satyam provided to the engagement team. The engagement team could have, but did not, contact the banks directly to determine the amounts that Satyam had on deposit with the banks. Had the engagement team done so, such inquiry should have revealed that cash and cash equivalent balances reported in Satyam's financial statements were significantly overstated. The following chart provides several examples of these differences:

Period Ending	Bank	Confirmations PW India Received Directly from Bank (in $ USD)	Confirmations PW India Received from Satyam (in $ USD)
9/30/08	BNP Paribas	$1,860,280	$100,753,498
9/30/08	HSBC	No balance identified	$172,000,153
6/30/08	BNP Paribas	$1,919,404	$109,014,675
3/31/08	Citibank	$330,172	$152,923,538
3/31/08	HDFC	No balance identified	$175,952,024
3/31/07	BNP Paribas	$11,192,807	$108,584,687
3/31/06	BNP Paribas	$13,082,509	$96,830,036
3/31/06	HSBC	No balance identified	$53,282,374

30. Rather than contact the banks to obtain an explanation for the differences, the engagement team erroneously accepted both confirmations as genuine and purported to "corroborate" the interest bearing fixed deposit balances with fabricated fixed deposit receipts and other support supplied by Satyam.

31. Respondents did not reconcile this potentially conflicting audit evidence during the fiscal years 2005, 2006, 2007 and 2008. After the fraud was revealed, members of the Satyam engagement team indicated that they had ceded control of the confirmation process to the client and relied on Satyam's representations, in large part, because they believed that Satyam's former chairman and senior management were honest and that they did not suspect that Satyam was fabricating audit documents. Members of the Satyam engagement team conceded that, in hindsight, the confirmation process they employed for the Satyam audits was not in compliance with PCAOB Standards.

32. During Satyam's fiscal year 2008 audit, a partner from another PwC Network Firm outside of India ("The PwC Network Firm Partner") alerted members of the Satyam engagement team that its cash confirmation procedures appeared substantially deficient. Specifically, in May 2008, in response to questions raised by the "Appendix K filing reviewer" of Satyam's draft Form 20-F,[8] PW India requested that the PwC Network Firm Partner review the electronic workpapers

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[8] Under Rule 3400T(b), *Interim Quality Control* Standards, audit firms must comply with portions of the Requirements of Membership of the AICPA SEC Practice Section ("SECPS"). Audit firms associated with international firms are required to seek the adoption of policies and procedures consistent with the objectives set

for the 2008 Satyam audit. In response to that request, the PwC Network Firm Partner provided the Satyam engagement team with a detailed set of comments, including remarks on the cash and interest bearing deposit confirmation workpapers. In particular, the PwC Network Firm Partner informed the Satyam engagement team that their cash confirmation procedures appeared inadequate because the working papers indicated that "the confirmation was obtained either directly or from copies obtained from the client. We can only take credit for confirms we send and receive directly."

33. Notwithstanding the above-described warnings it received from the PwC Network Firm Partner, the Satyam engagement team failed to take any corrective action to confirm Satyam's cash and cash equivalent balances in a manner that complied with PCAOB Standards during the fiscal year 2008 audit. Had direct confirmation of the BOB bank balances been performed in response to the PwC Network Firm Partner's comment, Satyam's fraud could have been uncovered in the summer of 2008.

34. Respondents failed to perform the 2005-2008 Satyam audits with respect to cash and cash equivalent balances in accordance with PCAOB Standards. First, Respondents failed to maintain control over confirmation requests and responses by establishing direct communication between the intended recipient and the auditor to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses, as required by PCAOB Standard *AU § 330*.28. Second, Respondents failed to exercise appropriate professional skepticism throughout the confirmation process, as required by PCAOB Standard *AU § 330.15*. Third, Respondents failed to comply with PCAOB Standards *AU § 333.02 and 326.01* when it neglected to obtain sufficient competent evidential matter to afford a reasonable basis to determine the accuracy and completeness of the cash and cash equivalent balances reported in the financial statements. Instead, Respondents repeatedly substituted management representations for competent evidence, which also does not comply with PCAOB Standards *AU § 333.02 and 326.01*. Fourth, Respondents failed to take appropriate action in response to warning signs regarding the sufficiency of the cash confirmation procedures and caused the issuance of inaccurate audit reports, which resulted from a failure to comply with the several PCAOB Standards, including *AU § 230.07* ("[d]ue professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.") and *AU § 230.09* ("[i]n exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.").[9] The failure to properly execute third-party confirmation procedures contributed to the fraud at Satyam going undetected for years.

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forth in the Requirements of Membership of the SECPS at Appendix K, SECPS Section 1000.45 ("Appendix K"). *See* SECPS Section 1000.08(n). Those objectives include having policies and procedures for certain filings of SEC registrants which are the clients of foreign associated firms to be reviewed by persons knowledgeable in PCAOB standards.

[9] *See also* PCAOB Standards *AU § 150.02 and AU § 230,* which require due professional care to be exercised in the performance of the audit and preparation of the report.

Deficiencies in the Cash Confirmation Process
Occurred Throughout PW India

35. From at least 2008 forward, the failures in the confirmation process on the Satyam audit were not limited to that engagement, but were indicative of a quality control failure throughout PW India. In a large number of other audit engagements conducted by PW India, its auditors planned to test the existence and valuation of cash balances by performing direct confirmations, and then failed to control the confirmation process by relying on audit clients for confirmation requests and responses. PW India's quality control system failed to detect that, for several years, and on multiple audit engagements, audit personnel at PW India were not complying with PCAOB standards governing the cash confirmation process.

36. PW India staff conceded that they routinely relinquished control of the delivery and receipt of cash confirmations entirely to their audit clients and rarely, if ever, questioned the integrity of the confirmation responses they received from the client by following up with the banks prior to January 2009. Similarly, PW India partners, including a partner formerly responsible for audit risk and quality throughout PW India, indicated that client involvement in the confirmation process during the relevant period was the norm because bankers rarely, if ever, responded directly to confirmation requests made by auditors.

37. Despite annual quality reviews, PW India did not recognize the extensive nature of this quality control failure until after January 2009, when PW India conducted a firm-wide review of confirmation workpapers taken from completed and ongoing engagements for the current and prior fiscal year.

PW India's Audits of Accounts Receivable Balances
Were Not Performed in Accordance with PCAOB Standards
for Fiscal Years 2006-2008

38. During the relevant period, Satyam's former senior management recorded fictitious receivables by exploiting weaknesses in the internal controls of the company's accounts receivable system. Specifically, the company's invoicing system allowed for the manual entry of customer invoices via the intervention of a "super user," acting outside the regular controls of the billing and invoicing process. Satyam's former senior management used this super user function to create thousands of fake invoices totaling over $1 billion during the entirety of the fraud.

39. For the 2006-2008 fiscal year audits, Respondents failed to carry out the audits of the accounts receivable balance in accordance with PCAOB Standards. As with the cash confirmation process, the Satyam engagement team did not maintain control of the accounts receivable confirmations and did not perform adequate follow-up procedures on confirmations that were sent but not received from customers with purported accounts receivable balances recorded on Satyam's 2006-2008 fiscal year end financial statements.

40. For example, from the period March 31, 2006 through August 31, 2007, the Satyam engagement team prepared accounts receivable confirmation requests on five occasions but received few, if any, responses to those requests. During the relevant period, Respondents made no attempt to follow up on those non-responses. Further, as part of the 2007 fiscal year audit, the engagement team sent out confirmation requests to 22 customers with outstanding receivables balances on August 31, 2006, including seven that were later exposed as fictitious customers. No customers responded to those requests. Appropriate diligence and follow-up procedures could have exposed the true nature of these customers.

41. In other periods, instead of employing confirmation procedures to verify accounts receivable balances, the Satyam engagement team purported to implement "alternative procedures" to validate receivables through an attempt to verify their subsequent receipts. The subsequent receipt totals were obtained from Satyam's management and then divided by the total outstanding receivables as of the period end to arrive at a percentage of receivables that had been subsequently collected. There was no other documented substantive analysis to go along with this calculation. The above-described alternative audit procedures performed during the 2006-2008 fiscal audit years did not provide adequate audit evidence to corroborate the existence of receivables because they were not designed to ensure that the subsequent receipts had any relationship to the actual outstanding receivables at the end of the respective fiscal year.

42. Further, the engagement team was aware of factors that increased the potential for fraud at Satyam during at least the fiscal year 2007 audit, but failed to recognize the increased risk, and therefore did not alter its planning and execution of the Satyam audits to take these risks into account as required under PCAOB Standards. In connection with the audit of the company's fiscal year ended March 31, 2007, PW India's Systems and Process Assurance ("SPA") personnel tested Satyam's Information Technology ("IT") internal controls. This testing revealed over 170 deficiencies in those controls, including eight significant deficiencies identified by the SPA team. The nature of these deficiencies should have alerted the engagement team to a heightened risk with respect to receivables.

43. In an area that called for increased audit vigilance, Respondents failed to develop an audit plan that addressed the increased risk of a material misstatement of the receivables balance. Instead, the 2007 and 2008 year-end audits excluded confirmation of the year-end receivables balances.

44. Respondents failed to adequately plan and perform the 2006-2008 audits with respect to accounts receivable in accordance with relevant PCAOB Standards. First, the engagement team ignored internal control deficiencies which should have alerted it to the heightened fraud risk with respect to receivables, as required by PCAOB Standards *AU § 312.16* (an auditor must consider the effect of an assessment of the risk of material misstatement due to

fraud on the overall audit strategy).[10] Second, the receivables audit plan failed to address an increased risk of a material misstatement of the receivables balance, as required by PCAOB Standard *AU § 312.17* (higher risk may cause the auditor to expand or modify the extent or nature of procedures to obtain more persuasive evidence). Third, the engagement team failed to follow up on confirmation requests that were not returned, which resulted in a failure to comply with several PCAOB Standards, including *AU § 316.28* (describing instances in which audit procedures need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information, including from independent sources), *§330.30* (describing follow-up confirmation request process), and *§330.32* (describing alternative procedures to be employed in the examination of accounts receivable, including the matching of subsequent cash receipts with the actual items being paid). Fourth, Respondents did not obtain sufficient competent evidential matter to verify the existence of receivables, as required by PCAOB Standard *AU § 326.01.*[11]

Failure to Issue Accurate Audit Reports

45. PCAOB Standards require that the auditor's report contain an opinion on the financial statements taken as a whole and contain a clear indication of the character of the auditor's work. PCAOB Standard *AU § 508.04*. The auditor can determine that he or she is able to issue an audit report containing an unqualified opinion only if he has conducted his audit in accordance with PCAOB Standards and that the financial statements have been prepared in conformity with GAAP. PCAOB Standard *AU §§ 508.08, 508.14.*[12]

46. PW India acted unreasonably in rendering audit reports containing unqualified opinions for the fiscal year 2005-2008 publicly-filed financial statements. PW India issued audit reports on Satyam's financial statements even though they should have known that Satyam's audits had not been conducted in accordance with PCAOB Standards and that Satyam's financial statements did not present fairly, in all material respects, Satyam's financial position, operating results, and cash flows in conformity with GAAP.

PW India Did Not Comply with PCAOB Auditing Standard No.3.

47. PW India was notified by the PCAOB in November 2007 that the PCAOB would perform an inspection of PW India. This inspection was to include a review of PW India's 2007 fiscal year audit of Satyam. The audit opinion included in Satyam's 2007 Form 20-F was dated

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[10] *See also* PCAOB Standard *AU § 110.02*, which requires that an "auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

[11] *See also* PCAOB Standards *AU § 150.02 and AU § 230,* which require due professional care to be exercised in the performance of the audit and preparation of the report.

[12] PCAOB Standard *AU § 508.14* was in effect for reports issued from the beginning of the relevant period until November 15, 2008.

and released on April 27, 2007. Satyam submitted its Form 20-F to the SEC on April 30, 2007. The PCAOB inspection began in February 2008.

48. Under PCAOB Auditing Standard No. 3, *Audit Documentation* ("AS No. 3"), audit documentation may not be deleted after the document completion date (*i.e*, the date that the "complete and final set of audit documentation" has been assembled for retention, which must occur within 45 days after the audit report release date). AS No. 3 ¶15. AS No. 3 also requires that an auditor make certain written disclosures if the auditor adds or alters working papers after the documentation completion date. In particular, AS No. 3 specifies, in relevant part, that any additions or alterations to audit documentation after the audit report release date "must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it." AS No. 3 ¶16.

49. After the audit "documentation completion date," but before the PCAOB inspection of the Satyam audit for fiscal year ended March 31, 2007, members of the Satyam engagement team created certain documents, and gathered other documents, none of which previously were in the 2007 Satyam audit workpapers. The workpapers added by the Satyam engagement team included the management letter and debtor confirmation requests. The added workpapers did not include any notations indicating that they were added or altered after the documentation completion date. The added workpapers also neglected to provide the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it. Accordingly, PW India failed to comply with AS No.3 ¶¶ 15, 16.

E. VIOLATIONS

Because of Its Failure to Comply With PCAOB Standards, PW India Was a Cause of Satyam's Violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Relevant Rules Thereunder

50. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-16 thereunder require issuers with registered securities to file and furnish factually accurate annual and other reports. Rule 12b-20 of the Exchange Act requires that, in addition to the information expressly required to be included in such reports, the reports shall contain such further material information as may be necessary to ensure that the required statements are not misleading. As a foreign private issuer, Satyam is required to file annual reports on Form 20-F pursuant to Rule 13a-1 under the Exchange Act and to furnish reports on Form 6-K pursuant to Rule 13a-16 under the Exchange Act. The information required by Form 6-K is whatever information the registrant makes, or is required to make, public pursuant to the laws of the jurisdiction of its domicile or in which the registrant is incorporated or organized. The obligation to furnish these periodic reports includes the obligation that they be true and correct in all material respects. *See, e.g., SEC v. IMC International, Inc., 384* F.Supp. 889, 893 (N.D. Texas), aff'd mem. 505 F.2d 733 (5^{th} Cir. 1974), cert. denied sub nom. No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-16, and 12b-20 thereunder.

51. Under Section 21C of the Exchange Act, the Commission may "enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation." Exchange Act, 15 U.S.C. § 78u-3. Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *See KPMG Peat Marwick LLP*, 74 SEC Docket 384, 421 (2001), *recon. denied*, 74 SEC Docket 1351 (Mar. 8, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002), *reh'g en banc denied*, 2002 U.S. App. Lexis 14543 (July 16, 2002).

52. Satyam violated Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-16 thereunder by including in numerous of its periodic filings and submissions financial statements for the years 2005-2008 that were materially false and misleading. For each of those years, PW India issued audit reports containing unqualified opinions stating that "Price Waterhouse" conducted an audit of the company's annual financial statements in accordance with PCAOB Standards, that Satyam's financial reporting was in conformity with GAAP, and that Satyam's reporting results fairly represented the financial condition of the company. PW India consented to the inclusion of these audit reports in Satyam's Forms 20-F for fiscal years 2005 through 2008. However, PW India's audit reports were inaccurate because PW India failed to conduct its audits in accordance with PCAOB Standards. PW India's failure to comply with PCAOB Standards was a cause of Satyam's violations, including Satyam's failure to disclose to investors that it was engaged in non-GAAP and other accounting actions that prevented Satyam's reported financial results from fairly representing its financial condition.

53. In auditing Satyam's accounts receivable and cash and cash equivalent balances, Respondents did not comply with PCAOB Standards by failing to exercise due professional care and skepticism, failing to obtain sufficient competent evidential matter and substituting management's representations for those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements. In fact, the engagement team never insisted on, nor obtained, direct third-party confirmations for Satyam's largest cash account, nor did it perform sufficient audit procedures to determine whether Satyam's accounts receivable and cash and cash equivalent balances were not materially misstated. As a result, PW India was a cause of Satyam's failure to file and furnish annual and other reports to the Commission that were complete and accurate in all material respects in violation of Section 13(a).

54. Section 13(b)(2)(A) of the Exchange Act requires issuers of registered securities to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. Satyam violated Section 13(b)(2)(A) of the Exchange Act by recording thousands of fictitious entries that resulted in the false reporting of over $1 billion in non-existent revenue and cash. As described above, PW India failed to conduct its audits in accordance with PCAOB Standards, which allowed Satyam to utilize accounting devices that did not comply with GAAP. Had it done so, PW India would have reasonably determined that Satyam failed to keep books and records that accurately

reflected transactions in violation of Section 13(b)(2)(A) of the Exchange Act. Accordingly, PW India's actions were a cause of Satyam's Section 13(b)(2)(A) violations..

Section 10A(a) of the Exchange Act

55. Section 10A(a) of the Exchange Act requires each audit to include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts. No showing of scienter is necessary to establish a violation of Section 10A. *SEC v. Solucorp Industries, Ltd.*, 197 F. Supp. 2d 4 (S.D.N.Y. 2002).

56. PW India violated Section 10A(a) of the Exchange Act by failing to conduct procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts, particularly after PW India: (1) failed to conduct the appropriate inquiry after receiving fixed deposit confirmations, in the requested format, directly from branches of certain banks that purportedly held Satyam's largest interest bearing fixed deposit balances that were potentially conflicting with confirmations it received from Satyam management that did not conform to the format requested by the engagement team, a situation that should have alerted PW India to a heightened risk that Satyam's reported deposit balances were materially overstated; and (2) discovered "significant deficiencies" in Satyam's internal controls that should have caused PW India to take additional procedures to address the heightened risk of material misstatement of Satyam's receivable balance during the 2007 fiscal year audit.

Rule 102(e) and Section 4C of the Exchange Act

57. Rule 102(e)(1)(ii) of the Commission's Rules of Practice and Section 4C of the Exchange Act authorize the Commission to censure or deny, temporarily or permanently, the privilege of appearing or practicing before the Commission to accountants who are found to have engaged in improper professional conduct. Under Rule 102(e)(1)(iv), the term "improper professional conduct" means, in part, "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."

58. PW India caused Satyam to file and furnish materially inaccurate audit reports by representing that the audits were conducted in accordance with PCAOB Standards. Based on their violations of applicable professional standards, PW India was a cause of Satyam issuing materially false financial statements. This conduct supports an action against PW India under Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Rules of Practice.

F. FINDINGS

59. Based on the foregoing, the Commission finds that PW India engaged in improper professional conduct in connection with the 2005-2008 Satyam audits pursuant to Rule

102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice and Section 4C of the Exchange Act. Additionally, the Commission finds that PW India violated Section 10A(a) of the Exchange Act and was a cause of Satyam's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 13a-1, 13a-16, and 12b-20 thereunder.

G. REMEDIAL ACTIONS

60. After January 2009, but before entry of this Order, PW India has taken a series of remedial steps intended to enhance its audit quality controls in such areas as third-party confirmations, engagement training and staffing, engagement review, and risk management. PW India has also engaged senior audit professionals from PwC Network Firms outside India to review completed and ongoing audit engagements to evaluate and assess PW India's existing audit quality and to identify U.S.-related audit practice areas in need of improvement to be addressed by the undertakings set forth in this Order.

61. In addition, PW India suspended its Satyam audit engagement partners from all work and removed from client service all senior audit professionals (*i.e.*, managers and above) on the former Satyam audit team. After January 2009, but before the entry of this Order, PW India replaced virtually all senior management responsible for audit matters ("Assurance Leadership Team"). During this period, PW India also seconded several partners and other senior audit professionals from PwC Network Firms outside of India to add full-time audit infrastructure leadership and support throughout India.

H. UNDERTAKINGS[13]

PW India undertakes the following:

1. <u>Acceptance of New SEC Issuer Audits</u>. From the date of this Order, PW India shall not accept any new SEC Issuer Audits prior to the Interim Certificate of Compliance Date (defined at Paragraph 11). The term "SEC Issuer Audit(s)" is defined to mean an engagement to audit the consolidated financial statements filed with the Commission of an "Issuer" as that term is defined in Section 2(a)(7) of the Sarbanes-Oxley Act of 2002. Following the later of March 31, 2012 or the Interim Certificate of Compliance Date, PW India shall conduct any new SEC Issuer Audit pursuant to the Interim Conditions set forth in Paragraph 3 until the Final Certificate of Compliance Date (defined at Paragraph 12). Until the Final Certificate of Compliance Date, PW India agrees that the Lead Engagement Partner ("Lead Partner") on any SEC Issuer Audit must be deemed not unacceptable to the Independent Monitor (defined at Paragraph 10) before PW India commences work on any SEC Issuer Audit.

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[13] In determining to accept the Offer, the Commission further considered PW India's representations that: (1) it had not accepted any new SEC Issuer Audits or SEC Issuer Referred Engagement Work since January 2009; and (2) it would voluntarily extend all relevant undertakings set forth in Section III.H to the five other India-based PwC Network Firms.

2. Acceptance of SEC Issuer Referred Engagement Work. PW India shall not accept SEC Issuer Referred Engagement Work for a new client for a period of six months following the date of this Order. The term "SEC Issuer Referred Engagement Work" is defined to mean instances in which PW India: (a) conducts a full scope audit and provides, or should provide, consistent with Applicable Professional Standards (defined at Paragraph 3.a.), an interoffice opinion for an SEC Issuer-affiliated entity in connection with the audit of the SEC Issuer's consolidated financial statements filed with the Commission; or (b) provides audit work for an SEC Issuer-affiliated entity in connection with the audit of the SEC Issuer's consolidated financial statements filed with the Commission that constitutes ten percent or more of the SEC Issuer's consolidated assets, revenues, or expenses, as measured by the SEC Issuer's most recent fiscal year financial statements filed with the Commission. The term SEC Issuer Referred Engagement Work excludes Indian statutory audits for SEC Issuer-affiliated clients, SAS 70 reports (or, after June 15, 2011, SSAE No. 16 reports), and Shared Service Center Engagements (as defined in Paragraph 14). The term "new client" shall mean an SEC Issuer or a component of an SEC Issuer where PW India: (i) has not provided any audit or review services to the SEC Issuer or any of its components after January 1, 2010 through the date of this Order; and (ii) seeks to provide audit or review services to the SEC Issuer or any of its components after the date of this Order. After a period of six months following the date of this Order and until the Final Certificate of Compliance Date, PW India shall conduct SEC Issuer Referred Engagement Work for new clients pursuant to the Interim Conditions set forth in Paragraph 3.

3. Interim Conditions. From April 1, 2011 until the Final Certificate of Compliance Date, PW India shall conduct SEC Issuer Referred Engagement Work for current clients pursuant to the conditions set forth below ("Interim Conditions"). Upon expiration of the relevant restricted periods specified in Paragraphs 1 and 2 above and until the Final Certificate of Compliance Date, PW India agrees that any new SEC Issuer Audit and any SEC Issuer Referred Engagement Work for a new client shall be subject to the following Interim Conditions:

a. Staffing and Selection of Lead Partners, Engagement Managers, and Quality Review Partners. PW India's Assurance Leadership Team ("ALT"), a group which shall include, among others, PW India's Assurance Leader and Risk & Quality Leader, shall select, as part of meeting their quality control requirements, the Lead Partner, Engagement Manager, and Quality Review Partner ("QRP"), if required, for each SEC Issuer Audit and SEC Issuer Referred Engagement Work after taking into account his or her respective performance on SEC Issuer Audits, SEC Issuer Referred Engagement Work, and SEC Issuer-related client engagements that do not meet the thresholds described in Paragraph 2 (collectively "SEC Issuer-Related Audit Engagements") as indicated by the results of the Real Time Review and Engagement Compliance Review ("ECR") programs (Paragraph 9 and 10) and the real time review program undertaken by PW India during 2010. PW India undertakes to engage the engagement partner from the PwC Network Firm which is the lead auditor of the relevant SEC Issuer client ("Global Engagement Partner") to review the selection of any Lead Partner, Engagement Manager, and QRP before the commencement of any SEC Issuer Referred Engagement Work. PW India shall provide the Global Engagement Partner with a summary of the results of the engagement quality review conducted in October 2010, any ECR conducted subsequent to the date of this Order, and any real time review conducted during 2010 for each engagement on which the partner or manager served as Lead Partner or Engagement Manager and shall provide the Global Engagement Partner with access to any other relevant information upon request. PW India agrees that, in the event the Global Engagement Partner informs PW India that he or she objects to the selection of the Lead Partner, Engagement Manager or QRP to perform such work, PW India will select an alternative candidate that meets the conditions described in this Paragraph.

A QRP shall be assigned for all SEC Issuer Referred Engagement Work that meets the 10 percent of assets, revenues, or expenses threshold in Paragraph 2. For SEC Issuer Referred Engagement Work that does not meet the 10 percent of assets, revenues, or expenses threshold, a QRP will be assigned, if requested by the Global Engagement Partner. The scope of the QRP's role on such work shall be consistent with PCAOB Auditing Standard No. 7, Engagement Quality Review.

Any PW India partner or manager who served as the Lead Partner or Engagement Manager on any engagement that received an overall finding of unsatisfactory due to departures from Applicable Professional Standards[14] in connection with the engagement quality review conducted in October 2010 or any ECR performed subsequent to the date of this Order shall not be permitted to perform any SEC Issuer Audit or SEC Issuer Referred Engagement Work as a Lead Partner or Engagement Manager for a period of two fiscal years following the date of an overall finding of "unsatisfactory." Provided, however, that if PW India believes that an individual partner or manager whose engagement received an "unsatisfactory" rating should be exempt from the two-year practice restriction, then PW India, through its Assurance Leader, may make a written submission to the Independent Monitor explaining the reasons therefore and the Independent Monitor shall have the authority to exempt the individual partner or manager if he or she believes it is appropriate to do so. In no event, however, shall a partner or manager who receives an overall rating of "unsatisfactory" due to departures from Applicable Professional Standards in two consecutive quality reviews be exempt from the two-year practice restriction.

If a partner has an engagement on which he or she served as Lead Partner assessed as unsatisfactory due to departures from Applicable Professional Standards in an engagement quality review or ECR, that partner shall not be permitted to serve as a QRP on any SEC Issuer Audit or SEC Referred Work Engagement for a period of two fiscal years following the date of an overall finding of "unsatisfactory."

[14] The term "Applicable Professional Standards" means "professional standards" as defined in Section 2(a)(10) of the Sarbanes-Oxley Act of 2002 as amended.

PW India shall comply with the conditions described in this Paragraph on a continuing basis until the Final Certificate of Compliance Date.

b. Training. In addition to the training-based undertakings set forth in Paragraph 5, PW India agrees to require the Lead Partner, QRP, and Engagement Manager to complete at least: (a) eight hours of ethics training on an annual basis; and (b) 40 hours of specialized training in U.S. GAAP, PCAOB Standards,[15] and International Financial Reporting Standards ("IFRS") before initiating any SEC Issuer Audit or SEC Issuer Referred Engagement Work and at least 16 hours of such training in each subsequent year that such work is performed. Training programs completed after June 2010 shall be credited towards satisfying the 40 hour specialized training requirement of this Paragraph. The specialized training requirements of this Paragraph may also satisfy the specialized training hours requirements of Paragraph 5(d). All other PW India audit staff on any SEC Issuer Audit or SEC Issuer Referred Engagement Work shall be subject to the training undertakings set forth in Paragraph 5.

c. Consultations. PW India undertakes to review all consultations with PW India's National Office concerning Applicable Professional Standards required by PW India's consultation policy ("Required Consultations") involving any SEC Issuer Referred Engagement Work with the Global Engagement Partner.

Before accepting any SEC Issuer Audit, PW India undertakes to develop a process for review of all Required Consultations by an auditor from a PwC Network Firm outside of India. Such process must be reviewed and deemed acceptable by the Independent Monitor.

PW India further undertakes to resolve all Required Consultations in a manner consistent with PW India policies and procedures prior to the issuance of any opinion, report, or engagement completion document by PW India.

d. Pre-opinion Reviews. PW India undertakes, prior to the issuance of any opinion, report, or engagement completion document by PW India, to: (i) engage the Global Engagement Partner, or his or her partner or manager designee, to conduct a review of any PW India SEC Issuer Referred Engagement Work; and (ii) conduct a Real Time Review (Paragraph 9) of all SEC Issuer Audits.

4. Ongoing Cooperation. PW India (including its partners, principals, officers, agents and employees) shall cooperate fully with the Commission with respect to this action and any related

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[15] References in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission. See Release Nos. 33-8422; 34-49708; FR-73 at http://www.sec.gov/rules/interp /33-8422.htm.

judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party and subject to compliance with applicable law. PW India agrees that such cooperation shall include, but is not limited to:

a. Production of Information – at the Commission's request, upon reasonable notice, and without subpoena, PW India (including its partners, principals, officers, agents and employees) shall truthfully and completely disclose all information requested by SEC staff in connection with the Commission's investigation, litigation or other proceedings, except with respect to information related to clients other than Satyam, which information shall be produced in response to subpoena or other appropriate legal process;

b. Production of Documents -- at the Commission's request, upon reasonable notice, and without subpoena, PW India (including its partners, principals, officers, agents and employees) shall provide any document, record, or other tangible evidence requested by SEC staff in connection with the Commission's investigation, litigation or other proceedings, except with respect to documents related to clients other than Satyam, which documents shall be provided in response to subpoena or other appropriate legal process; and

c. Production of Cooperative Personnel – at the Commission's request, upon reasonable notice, and without subpoena, PW India (including its partners, principals, officers, agents and employees) shall use its best efforts to secure the attendance and truthful statements or testimony of any PW India partner, principal, officer, agent, or employee, excluding any such person who is a party to litigation with the Commission, at any meeting, interview, testimony, deposition, trial, or other legal proceeding.

The foregoing obligations are subject to PW India's reservation of rights:

(i) to claim that documents or information requested is subject to attorney-client privilege or attorney-work-product protection; and

(ii) to seek entry of a confidentiality order as to (aa) sensitive business documents or information, (bb) sensitive personnel documents or information, or (cc) confidential information pertaining to clients other than Satyam.

PW India further agrees that, with respect to this action and any related judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party, it will: (i) accept service by email, mail or facsimile transmission of notices, requests, or subpoenas issued by the Commission for documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by the Commission staff ("Commission Service"); (ii) appoint PW India's undersigned attorney as agent to receive Commission Service; (iii) with respect to Commission Service, waive the territorial limits upon service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses PW India's travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (iv) consent to personal jurisdiction over PW India in any United States District Court for purposes of enforcing any Commission Service.

5. Training and Professional Development. PW India shall evaluate its existing professional development policy and shall make such revisions deemed necessary in order to adopt, implement, and enforce written policies and procedures designed to provide its audit professionals with reasonable training and education to minimize the risk of future violations of Applicable Professional Standards and United States federal securities laws and regulations. PW India agrees that such training and education shall include subjects relevant to the audits of SEC Issuer-Related Audit Engagements. To that end, PW India shall require that all audit professionals complete a training curriculum in the areas of traditional core audit and accounting, Applicable Professional Standards, professional skepticism, behavioral change management, technical audit competence, ethics standards, electronic and hard-copy audit documentation standards (including, as they relate to PCAOB inspections), acceptable and appropriate third-party confirmation procedures, and other relevant technical audit training.

a. Training Programs. Prior to March 31, 2011 and until the Final Certificate of Compliance Date, PW India agrees and undertakes to provide annually, two-week training programs covering the above-referenced audit topics as well as training and presentation skills to select PW India audit professionals who thereafter will lead the training of other PW India audit professionals. After March 31, 2011, only PW India audit professionals who have successfully completed a two-week training program will be permitted to lead training of other PW India audit professionals.

b. Mandatory Annual Training. Prior to December 31, 2011 and until the Final Certificate of Compliance Date, PW India agrees and undertakes to require that all audit professionals complete an annual three-day program that includes training on the following topics: (i) audit basics; (ii) new audit and accounting standards; (iii) emerging issues in the profession; (iv) specific audit and accounting challenges identified in prior years' PW India audits; and (v) the role of the engagement quality reviewer.

c. Professional Skepticism Training. Prior to December 31, 2011, PW India agrees and undertakes to require that all audit professionals complete an eight-hour program that covers acceptable and appropriate professional skepticism and fraud detection. The course will be offered annually thereafter to new hires, through the Final Certificate of Compliance Date.

d. Specialized Training. In addition to the training and education described in Sections 5.b. and 5.c., all PW India audit professionals must complete successfully the following core audit curriculum and specialized training before they commence audit work for any SEC Issuer Audit or SEC Issuer Referred Engagement Work for financial statements after March 31, 2011:

(i) Minimum of 24 Hours of Audit-Related Training. The audit-related training requirement shall address the following topics: (1) assessing risks of material misstatements and developing responsive audit plans; (2) determining and documenting appropriate sampling methods and sample sizes, selecting samples, and evaluating and documenting results; (3) audit documentation; (4) obtaining and evaluating sufficient competent evidential matter; (5) acceptable and appropriate third-party confirmation procedures; (6) professional skepticism and corroboration of management's representations; (7) technical audit training; and (8) fraud detection. Training courses completed after June 2010 shall be credited towards satisfying the specialized audit training requirements of this Paragraph.

(ii) Minimum of 12 Hours of Specialized Training and Examination. Of the 24 hours of required audit-related training described above, a minimum of 12 hours shall involve live training taught by senior audit professionals from PwC Network Firms outside India, including those who have been seconded to PW India, who are experienced in auditing SEC Issuers and shall cover U.S. GAAP and PCAOB Standards. The live training shall be followed by an examination of the topics covered. PW India audit professionals must complete a minimum of 6 hours of such live training before they commence audit work for any SEC Issuer Audit or SEC Issuer Referred Engagement Work in each subsequent year.

e. Additional Training Programs. PW India agrees to consult with the Independent Monitor in designing its training and education program, and to submit to the Independent Monitor a detailed proposal within 60 days after retention of the Independent Monitor that describes the content and implementation of the training and education program. PW India undertakes and agrees to provide such additional training and workshops for its audit professionals on topics that include, but are not limited to: IFRS training; additional workpaper documentation standards; behavioral instruction; audit planning; PW India audit partner and manager supervisory training; audit quality training for all PW India audit partners; and other training deemed necessary to rectify deficiencies identified during the Quality Control Management Review and Engagement Compliance Review programs (described in Paragraph 9). The Independent Monitor shall review PW India's proposal describing the content and implementation of the training and education program; such program must be deemed not unacceptable to the Independent Monitor.

6. Ethical Code of Conduct and Associated Training. PW India has represented that it has a Code of Ethical Business Conduct (the "Ethics Code") that defines standards of behavior for PW India audit professionals. PW India undertakes to: (a) adopt procedures designed to ensure that the Ethics Code is disseminated to PW India audit professionals; (b) conduct appropriate ethics training; (c) review the Ethics Code on a regular basis and update it as needed; (d) adopt an

appropriate system of penalties to discourage and punish any violations of the Ethics Code; and (e) adopt procedures designed to verify, on a regular basis, compliance with the Ethics Code. In addition, PW India shall provide annual ethics training to PW India audit professionals deemed most likely to perform SEC Issuer-Related Audit Engagements.

7. Undertakings Concerning Staffing

a. Audit Infrastructure Support. PW India undertakes to increase the size and improve the expertise of its audit support personnel by adding full-time or full-time equivalent senior professionals (*i.e.*, managers and above) trained in and knowledgeable about U.S. GAAP and PCAOB Standards from within PW India and from PwC Network Firms outside India in all areas of audit support.

b. Engagement Staffing. PW India shall undertake to alter the structure of its engagement teams on SEC Issuer-Related Audit Engagements. Such measures shall include: (i) policies and procedures designed to address the detection and resolution of potential issues concerning the quality of audit work performed by senior audit professionals; (ii) policies and procedures designed to ensure the QRP's role is in compliance with PCAOB Auditing Standard No. 7; (iii) greater emphasis on partner and manager time and attention; (iv) regular coaching of junior audit professionals by experienced senior audit professionals; and (v) as indicated below, recruitment of client service partners and other senior audit professionals from PwC Network Firms outside India to increase the size and improve the expertise of PW India's audit personnel.

c. Secondment. PW India undertakes to increase the number of senior audit professionals seconded from PwC Network Firms outside India that are trained in and knowledgeable about U.S. GAAP and PCAOB Standards who will, among other responsibilities, be involved in the training of PW India audit professionals most likely to perform SEC Issuer-Related Audit Engagements. PW India also shall initiate an audit engagement exchange program for junior audit professionals to and from PW India with a particularized focus on the performance of integrated audit procedures on the financial statements of clients affiliated with an SEC Issuer.

8. Undertakings Concerning Audit Quality Management System. Prior to December 31, 2011, PW India shall revise as may be necessary, and then engage in steps to implement and enforce, such policies and procedures so as to provide reasonable assurance that PW India will comply with its obligations under professional, regulatory and firm requirements with respect to SEC Issuer-Related Audit Engagements. To that end, PW India agrees and undertakes to provide to the Independent Monitor for review and recommendation, its policies and procedures, including evidence of their implementation, concerning the following:

a. Completion of Planning Prior to the Commencement of Audit Fieldwork. Such policies and procedures shall provide reasonable assurance that, prior to the commencement of any significant audit procedures: (i) workpapers identify all significant risks requiring additional testing; (ii) workpapers identify all significant accounts and disclosures and their relevant assertions; (iii) workpapers document the risks of material misstatements, and that the planned nature, timing, and extent of testing are finalized and reviewed and approved by the Lead Partner, and, when appropriate, the QRP; and (iv) workpapers are tailored to address identified risks of material misstatement.

b. Third-Party Confirmations. Such policies and procedures shall be designed to provide reasonable assurance that all audit personnel perform third-party confirmation procedures in compliance with PCAOB Standards.

c. Consultations. Such policies and procedures shall set forth consultation procedures and documentation requirements regarding procedures for external review of PW India National Office Required Consultations, as well as for the resolution of such consultations.

d. Documentation. Such policies and procedures shall be designed to provide reasonable assurance that PW India's SEC Issuer-Related Audit Engagements comply with Auditing Standard No. 3, Audit Documentation. Such procedures shall emphasize that documentation must be prepared in sufficient detail for an experienced auditor, without prior knowledge of the engagement, to be able to reperform the work and require that any additions made after the documentation date[16] must identify the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it. Additionally, PW India shall adopt a policy making it mandatory that a Lead Partner on an SEC Issuer-Related Audit Engagement review each audit area designated by the engagement team as having a significant risk of material misstatement (whether due to fraud or error) for compliance with both PCAOB Standards and related rules and firm policies and procedures.

e. Detection and Reporting of Illegal Client Activity ("Section 10A Compliance"). Such policies and procedures shall be designed to provide reasonable assurance that PW India complies with Section 10A of the Securities Exchange Act of 1934, as amended, including without limitation, for each audit subject to Section 10A, procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement

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[16] PCAOB Auditing Standard No. 3, Paragraph 15, states, "A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (documentation completion date). If a report is not issued in connection with an engagement, then the documentation completion date should not be more than 45 days from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the documentation completion date should not be more than 45 days from the date the engagement ceased."

amounts, and to comply with all requirements under the standards of the Commission, the PCAOB, and Section 10A to evaluate and report suspected illegal acts.

f. Engagement Quality Control. Such policies and procedures shall be designed to provide reasonable assurance that PW India complies with the PCAOB's Auditing Standard No. 7, Engagement Quality Review.

g. Audit Opinions. Such policies and procedures shall be designed to provide reasonable assurance that the firm signing the audit report or opinion for an SEC Issuer-Related Audit Engagement shall uniquely identify itself by, at a minimum, its PCAOB-registered name, and the location of the registered office.

9. Audit Quality Environment

a. Real Time Reviews. From the date of this Order through at least the Interim Certificate of Compliance Date, PW India shall engage senior audit professionals from PwC Network Firms outside India with experience in both U.S. GAAP and PCAOB Standards to lead pre-opinion reviews of certain SEC Issuer-Related Audit Engagements ("Real Time Reviews"). All SEC Issuer Audits and a sample of other SEC Issuer-Related Audit Engagements, including at least one other SEC Issuer-Related Audit Engagement for each partner serving as Lead Partner on such an engagement, shall be subject to a Real Time Review each year. These reviews shall be designed to identify areas for improvement and to provide support to PW India audit engagement teams working on SEC Issuer-Related Audit Engagements. SEC Issuer Referred Engagement Work is subject to the pre-opinion reviews described in Paragraph 3(d) and shall be excluded from the Real Time Reviews.

b. Engagement Compliance Review. PW India shall engage senior audit professionals from PwC Network Firms outside India with experience in both U.S. GAAP and PCAOB Standards to review selected, completed PW India SEC Issuer-Related Audit Engagement workpapers as part of the ECR program in order to assess PW India's compliance with Applicable Professional Standards. The Independent Team Leader ("ITL") will select the engagements for review, which selection shall be part of the ECR planning and scope subject to review and recommendation by the Independent Monitor. As part of their engagement by PW India, these senior audit professionals shall develop an engagement quality review program designed to measure and assess compliance with Applicable Professional Standards and PW India partner performance on SEC Issuer-Related Audit Engagements through annual post-opinion evaluations of selected SEC Issuer-Related Audit Engagements. The ECR program will also identify remedial needs on an ongoing basis. As described further in Paragraph 10, the planning and scope of the ECR program shall incorporate recommendations made by the Independent Monitor. The ECR program shall be overseen by an ITL experienced in U.S GAAP and PCAOB Standards and will continue on an annual basis until the Final

Certificate of Compliance Date. All SEC Issuer Audits and SEC Issuer Referred Engagement Work shall be included as part of the annual ECR.

c. Quality Control Management Review. PW India shall engage senior audit professionals from PwC Network Firms outside India experienced in PCAOB Standards to devise and implement a quality control review program to measure and assess whether, and to what extent, PW India has in place systems, policies, and procedures to provide reasonable assurance that its audit personnel comply with applicable professional standards and PW India's standards of quality as defined by PCAOB Quality Control Standards[17] when performing work on SEC Issuer-Related Audit Engagements (herein referred to as "Quality Control Management Review or "QCMR").[18] As described further in Paragraph 10, PW India's QCMR program shall include an annual review of completed audit work measured against a series of key performance indicators that shall be developed, assessed, and updated on an ongoing basis. The planning and scope of the QCMR shall be overseen by the ITL and shall incorporate recommendations made by the Independent Monitor. The QCMR program shall continue on an annual basis until the Final Certificate of Compliance Date.

10. Undertakings Related to Reporting Requirements and the Role of the Independent Monitor

a. Independent Monitor Selection and Retention. PW India shall retain and pay for an independent third-party not unacceptable to PCAOB staff and Commission staff who has experience with public company reporting in the United States and is knowledgeable in Applicable Professional Standards ("Independent Monitor") to review PW India's compliance with the undertakings set forth in this Order. Within 60 days after the entry of this Order, PW India shall submit to PCAOB staff and Commission staff a proposal setting forth the identity, qualifications, and proposed terms of retention of the Independent Monitor. PW India may not retain as the Independent Monitor any individual or entity that has provided legal, auditing, or other services to, or has had any affiliation with, Satyam, PwC IL, or any PwC Network Firm during the prior two years.

PW India agrees that its engagement agreement with the Independent Monitor shall require the Independent Monitor to agree that, for the period of engagement and for a

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[17] References to "PCAOB Quality Control Standards" throughout this Order mean, collectively, QC Sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice;* QC Sec. 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*; QC Sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*; all amendments thereto, and any subsequently enacted related standards of the PCAOB.

[18] Staff recognizes that, subject to review and recommendation of the Independent Monitor, PW India also may develop procedures and measurements designed to review and evaluate the firm's quality control compliance with International Standard on Quality Control 1, which PW India represents may prove relevant in determining PW India's overall quality control environment.

period of two years from completion of the engagement, the Independent Monitor shall not enter into any employment, consultant, attorney-client, auditing, or other professional relationship with Satyam, PwC IL, or any PwC Network Firm, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such, and shall require that any firm with which the Independent Monitor is affiliated or of which the Independent Monitor is a member, or any person engaged to assist the Independent Monitor in performance of the Independent Monitor's duties under this Order not, without prior written consent of the PCAOB staff and Commission staff, enter into any employment, consultant, attorney-client, auditing, or other professional relationship with Satyam, PwC IL, or a PwC Network Firm, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

The term of the Independent Monitor shall expire upon the Final Certificate of Compliance Date. PW India shall not have the authority to terminate the Independent Monitor before the Final Certificate of Compliance Date without the prior written approval of the PCAOB staff and the Commission staff.

b. <u>Role and Responsibilities Overview</u>. As set forth in this Order, the Independent Monitor's roles and responsibilities shall include: (i) pre-appointment review of new members of PW India's Assurance Leadership Team and Lead Partners on SEC Issuer Audits – such individuals shall not be unacceptable to the Independent Monitor; (ii) approving the appointment of the ITL; (iii) reviewing and recommending revisions to the audit Quality Management System policies and procedures of PW India; (iv) reviewing and recommending revisions to PW India's ECR and QCMR programs and compliance work plans; (v) reporting upon PW India's progress after review and evaluation of PW India's semi-annual and annual reports set forth herein; (vi) assessing and recommending remedial steps deemed necessary to correct any deficiencies identified in the semi-annual and annual reports; (vii) preparing an annual written report concerning PW India's progress in implementing the undertakings; (viii) making findings as set forth in Paragraphs 11 and 12; and (ix) taking such reasonable steps as, in his or her view, may be necessary to fulfill his or her obligations set forth in this Order.

c. <u>Monitoring Compliance with Undertakings</u>. Within 60 days after retention of an Independent Monitor, PW India shall submit to the Independent Monitor a work plan that describes the manner in which PW India intends to set forth quantifiable goals in which it may measure its ongoing implementation of, and compliance with, the undertakings set forth in this Order. PW India undertakes to permit the Independent Monitor 30 days to make recommendations to its work plan and agrees to make a good faith effort to address and incorporate all such recommendations. PW India shall work cooperatively with the Independent Monitor to resolve any disagreements to the satisfaction of the Independent Monitor. If a matter that the Independent

Monitor believes is within his or her responsibility cannot be resolved, at the request of the Independent Monitor, PW India shall promptly provide written notice to the Independent Monitor and the PCAOB staff and Commission staff. Any disputes between PW India and the Independent Monitor with respect to the work plan shall be decided by the PCAOB staff and the Commission staff, and PW India shall abide by their decision.

For the period from the effective date of this Order to the Final Certificate of Compliance Date, PW India agrees and undertakes periodically, at no less than six-month intervals, to provide a written report to the Independent Monitor regarding PW India's progress regarding the implementation of, and compliance with, the undertakings set forth in this Order. On an annual basis, PW India shall provide the Independent Monitor with a written report that explains the circumstances surrounding any failure to meet specific quantifiable goals set forth in the work plan (as well as the specific audit involved, if any) and shall provide a detailed description of what steps, if any, PW India has taken and shall take to remedy any such failure. PW India's follow-up reviews shall incorporate comments provided by the Independent Monitor on PW India's prior reviews and reports. As part of PW India's compliance with the undertakings set forth in this Order, the Independent Monitor shall also assess and report annually to PCAOB staff and Commission staff whether PW India is complying with the undertaking regarding SEC Issuer Audits and SEC Issuer Referred Engagement Work (Paragraphs 2 and 3).

d. Monitoring Compliance with PW India's Quality Control Management Review and Engagement Compliance Review. Within 60 days after retention of an Independent Monitor, PW India undertakes to engage the ITL to submit to the Independent Monitor the QCMR and ECR proposed plans.

PW India agrees and undertakes that, until the Final Certificate of Compliance Date, the ITL and the two individuals with direct responsibility for the QCMR and ECR (the "Review Team Leaders") shall be senior audit professionals from a PwC Network Firm outside India with experience in U.S. GAAP and PCAOB Standards that have not participated in any quality review of PW India prior to September 2010. The ITL must be approved by the Independent Monitor and deemed not unacceptable to both PCAOB staff and Commission staff.

PW India undertakes to engage the ITL to permit the Independent Monitor 60 days to make recommendations to its QCMR and ECR proposed plans and engage the ITL to make a good faith effort to incorporate all such recommendations. PW India shall engage the ITL to work cooperatively with the Independent Monitor to resolve any disagreements to the satisfaction of the Independent Monitor. If the matter cannot be resolved, at the request of the Independent Monitor, PW India, through the ITL, shall promptly provide written notice to the Independent Monitor and the PCAOB staff and Commission staff. Any disputes between PW India or the ITL and the Independent

Monitor with respect to the QCMR and ECR proposed plans shall be decided by the PCAOB staff and the Commission staff, and their decision shall be final.

(i) Quality Control Management Review Reports. For the period from the effective date of this Order to the Final Certificate of Compliance Date, PW India agrees and undertakes to provide, through the ITL, an annual written report to the Independent Monitor that assesses – and provides documented and supportable findings – as to whether, and to what extent, there is reasonable assurance that PW India's quality controls with respect to SEC Issuer-Related Audit Engagements are in compliance with PCAOB Quality Control Standards. PW India shall undertake follow-up reviews each year until the Final Certificate of Compliance Date, incorporating comments provided by the Independent Monitor on PW India's prior reviews and reports, to further monitor and assess PW India's quality controls.

(ii) Engagement Compliance Review Reports. For the period from the effective date of this Order to the Final Certificate of Compliance Date, PW India agrees and undertakes to provide, through the ITL, an annual written report to the Independent Monitor that assesses and provides documented and supportable findings as to whether, and to what extent, PW India's audits of SEC Issuer-Related Audit Engagements are compliant with Applicable Professional Standards.[19] Such assessments and findings shall include, but not be limited to, documents sufficient to support the results developed from all engagement reviews from which the report is based. PW India shall undertake follow-up reviews each year until the Final Certificate of Compliance Date, incorporating comments provided by the Independent Monitor on PW India's prior reviews and reports, to further monitor and assess PW India's engagement quality.

(iii) Independent Monitor Annual Report. Within 90 days of receiving the ECR or QCMR report, whichever is later, and for the period from the effective date of this Order to the Final Certificate Date, the Independent Monitor shall prepare an annual report ("IM Report") that assesses whether the QCMRs and ECRs were conducted according to reasonable procedures and indicates whether the Independent Monitor supports the findings and conclusions set forth in the QCMR and ECR reports. The Independent Monitor may extend the time period for the IM Report for up to thirty calendar days upon prior written notice to PW India, PCAOB staff, Commission staff, and the ITL. Within 30 days of receiving the IM Report, PW India may prepare a written response to the IM Report. If the Final Certificate of Compliance does not take effect within three years of the date of this Order, each IM Report thereafter shall include an assessment regarding whether, and to what extent, PW India continues to make substantial progress toward satisfying the undertakings set forth in this Order.

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[19] The ITL may opt to issue a single, aggregate report that covers the annual results of both the QCMR and the ECR.

(iv) Remedial Measures Resulting from Annual Review Reports. To the extent that the annual ECR and QCMR reports, or the resulting IM Report, identify deficiencies or instances of non-compliance with respect to the standards articulated therein, PW India shall submit to the Independent Monitor a Remedial Plan within 60 days of its receipt of the IM Report. PW India shall permit the Independent Monitor 30 days to make recommendations to the remedial plan. PW India shall require the ITL to consult with the Independent Monitor and make a good faith effort to incorporate the remedial plan recommendations into the subsequent period's ECR and QCMR, as appropriate and PW India shall require the ITL to work cooperatively with the Independent Monitor to resolve any disagreements to the satisfaction of the Independent Monitor. If the matter cannot be resolved, at the request of the Independent Monitor, PW India, through the ITL, shall promptly provide written notice to the Independent Monitor and the PCAOB staff and Commission staff. Any disputes between the ITL and the Independent Monitor with respect to the remedial plan shall be decided by the PCAOB staff and the Commission staff, and their decision shall be final.

e. Reporting Requirements. PW India's Assurance Leader shall sign all QCMR, ECR, and Remedial Plan reports, attesting that he or she has read and understood their content and certifying satisfaction with any undertakings addressed, findings reached, and remedial steps required in the reports. PW India shall provide copies of all written reports described in this Paragraph to the appropriate PCAOB staff and Commission staff designees no later than 10 days from the date of completion.

f. Documentation Requirements. PW India agrees and undertakes to prepare and preserve a copy of all written plans, reports, and responses in connection with the undertakings set forth in this Order. In addition, PW India shall maintain sufficient documentation to provide a clear undertaking of its purpose, sources of support, and conclusions that form the basis of all reports set forth in this Order. PW India agrees and undertakes that all such documentation shall be made available to the Independent Monitor and, upon reasonable request, to PCAOB staff and Commission staff. All such documentation will be retained for two years following the Final Certification of Compliance Date.

11. Interim Certificate of Compliance. Upon a finding by the Independent Monitor that PW India: (i) has developed an acceptable process for the review of Required Consultations (Paragraph 3.c.) for SEC Issuer Audits by an auditor experienced in U.S. GAAP and PCAOB Standards from a PwC Network Firm outside India; (ii) has demonstrated significant progress toward completion of the undertakings set forth in this Order; and (iii) has evidenced reasonable assurances from the QCMRs and ECRs that there are no significant deficiencies or instances of material non-compliance with respect to an SEC Issuer Audit or SEC Issuer Referred Engagement Work completed and reviewed for the previous fiscal year, PW India's Assurance Leader shall certify in writing that it has satisfied each of the above specified conditions ("Interim Certificate of Compliance"). The Interim Certificate of Compliance shall identify each of the relevant reports in which PW India demonstrated written evidence of satisfaction in the

form of a narrative supported by exhibits sufficient to demonstrate compliance. The Interim Certificate of Compliance and supporting material shall be submitted to the appropriate Commission Division of Enforcement and PCAOB Division of Enforcement designee (the "Designees"). Upon receipt of the Interim Certificate of Compliance and any supporting material that the ITL and Independent Monitor deem necessary to support that Certificate, the Designees may make reasonable requests for further documents evidencing compliance and PW India agrees to provide the requested documents to the Designees and the Independent Monitor. Within the earlier of 30 days of receipt of the requested documents or 120 days after receipt of the Interim Certificate of Compliance, the Independent Monitor must either affirm or withdraw his or her initial findings regarding the Interim Certificate of Compliance in writing, a copy of which shall be provided to PW India, the ITL, and the Designees. The Interim Certificate of Compliance takes effect upon confirmation by both Designees that they have received the Independent Monitor's affirmation of findings in writing ("Interim Certificate of Compliance Date"), but in any event the Interim Certificate of Compliance Date shall not be before March 31, 2012.

12. Final Certificate of Compliance. Upon findings by the Independent Monitor that: (i) PW India has complied with the undertakings set forth in this Order; (ii) PW India has evidenced reasonable assurance that its quality controls in place for SEC Issuer-Related Audit Engagements are in compliance with PCAOB Quality Control Standards; and (iii) PW India has evidenced reasonable assurances that there are no significant deficiencies or instances of material non-compliance with respect to all of the SEC Issuer-Related Audit Engagements completed and reviewed for the previous two fiscal years, PW India's Assurance Leader shall certify in writing that it has satisfied each of the above specified conditions (the "Final Certificate of Compliance"). The Final Certificate of Compliance shall identify each of the relevant reports in which the Independent Monitor has found that PW India demonstrated written evidence of compliance in the form of a narrative supported by exhibits sufficient to demonstrate compliance. The Final Certificate of Compliance and supporting material shall be submitted to the Designees. Upon receipt of the Final Certificate of Compliance and the relevant reports, the Designees may make reasonable requests for further documents evidencing compliance and PW India shall provide the requested documents to the Designees and the Independent Monitor. Within the earlier of 60 days of the Designees' receipt of the requested documents or 120 days after the Designees' receipt of the Final Certificate of Compliance, the Independent Monitor must either affirm or withdraw his or her initial findings regarding the Final Certificate of Compliance in writing, a copy of which shall be provided to PW India, the ITL, and the Designees. The Final Certificate of Compliance takes effect upon confirmation by both Designees that they have received the Independent Monitor's affirmation of findings in writing. ("Final Certificate of Compliance Date").

13. PCAOB Inspections. PW India shall provide to the Independent Monitor inspection comment forms and responses and draft and final inspection reports pertaining to all PCAOB inspections of PCAOB-registered PW India firms that may occur from the date of this Order to the Final Certificate of Compliance Date. The goal of this undertaking is to provide the Independent Monitor with an opportunity to review and identify any criticisms or potential

defects in PW India's quality control system that would indicate PW India has failed to evidence reasonable assurance that its quality controls in place for SEC Issuer-Related Audit Engagements are in compliance with PCAOB Quality Control Standards. If the Independent Monitor concludes that the results of a PCAOB inspection of a PCAOB-registered PW India firm are inconsistent with his or her findings made in connection with Paragraph 12, the Final Certificate of Compliance Date will not take effect until the Independent Monitor provides a written report to PW India, the ITL, and the Designees that explains how the Independent Monitor has reconciled any such inconsistencies to his or her satisfaction.

14. From the date of this Order and until the Final Certificate of Compliance Date, PW India agrees and undertakes that its Shared Service Center Engagements shall be subject to the following conditions: (a) all workpapers prepared by PW India shall be provided to the Global Engagement Partner or his or her designee; (b) the Global Engagement Partner shall engage a senior audit professional from a PwC Network Firm outside India to oversee and control the execution of the Shared Service Center Engagement; and (c) the Global Engagement Partner shall assume all responsibility for the Shared Service Center Engagement. The term "Shared Service Center" shall mean an outsourcing facility that is a component of, or a third-party vendor to, an SEC Issuer and which operates, controls, and processes the SEC Issuer's group financial transactions. The term "Shared Service Center Engagement" shall mean an audit engagement in which the Global Engagement Partner for an SEC-issuer group that is audited by a PwC Network Firm instructs PW India to audit the controls and processing of group financial transactions by a Shared Service Center. Where PW India audits a Shared Service Center's own financial statements and that engagement meets the definition of SEC Issuer Referred Engagement Work, such engagement shall be subject to the limitations on acceptance of SEC Issuer Referred Engagement Work set forth in Paragraph 2 and the Interim Conditions set forth in Paragraph 3.

In determining whether to accept the Offer, the Commission has considered these undertakings. PW India agrees that if the Division of Enforcement believes that PW India has not satisfied these undertakings within a reasonable time, the Division of Enforcement may petition the Commission to reopen the matter to determine whether additional sanctions are appropriate.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 4C, 21B(a)(2)(B) and 21C of the Exchange Act, and Rule 102(e)(1)(ii) of the Commission's Rules of Practice, it is hereby ORDERED, effective immediately, that:

A. Respondents shall cease and desist from committing or causing any violation and any future violation of Section 10A(a) of the Exchange Act and from causing any violation and any future violation of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-16 thereunder;

B. Respondents shall, within 45 days of the entry of this Order, pay a civil money penalty in the amount of $6 million to the Securities and Exchange Commission. If the payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. 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 a notification that identifies Lovelock & Lewes, Price Waterhouse, Bangalore, Price Waterhouse & Co., Bangalore, Price Waterhouse Calcutta, and Price Waterhouse & Co., Calcutta as the Respondents in these proceedings as well as the file number of these proceedings. Respondents shall simultaneously transmit a copy of such payment and notification to Cheryl J. Scarboro, Chief, Foreign Corrupt Practices Act Unit, Division of Enforcement, 100 F Street N.E., Washington, DC 20549-5030. Respondents will cooperate with the staff of the Commission to obtain evidence of receipt of the payments set forth herein.

C. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund is created for the penalties referenced in Paragraph B above. Regardless of whether any such Fair Fund distribution is made, the civil penalty shall be treated as a penalty paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that they shall not, after offset or reduction of any award of compensatory damages in any Related Investor Action based on Respondents' payment of a civil penalty in this proceeding, argue that they are entitled to, nor shall they further benefit by offset or reduction of any part of such compensatory damages award by the amount of any part of Respondents' payment of a civil penalty in this proceeding ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this proceeding and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against any or all Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in this Order instituted by the Commission in this proceeding.

D. Respondents are censured pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice; and

E. Respondents shall comply with the undertakings enumerated in Section III.H. above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64185 / April 5, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3259 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14322

In the Matter of **MARC E. BERCOON,** **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 Marc E. Bercoon ("Respondent" or "Bercoon") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

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

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

II.

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

III.

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

1. Marc E. Bercoon, 50, has been an attorney who was licensed to practice law in the State of Illinois until 2008, and has held himself out as a Certified Public Accountant, or as having passed the CPA examination. Bercoon has held various positions with public companies, including General Counsel and Secretary of one public company from February 1993 to February 1994, and Senior Vice President beginning in February 1994; Chief Financial Officer and President of another public company from February 28, 2005, to April 28, 2005, and from April 28, 2005, to June 6, 2006, respectively; and Assistant Secretary for a third public company as of March 25, 2005.

2. LADP Acquisition, Inc. ("LADP") is a Delaware corporation located in Atlanta, Georgia. Bercoon exercised control over this company. On January 8, 2010, the State of Pennsylvania issued a cease and desist order against LADP to halt the unregistered offering of LADP shares. LADP has no business operations.

3. On February 11, 2011, a Judgment was entered against Bercoon, permanently enjoining him from future violations of Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933 and 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. LADP Acquisition, Inc. et al., Civil Action Number CV10-6835, in the United States District Court for the Central District of California. Bercoon was also ordered to pay disgorgement of ill-gotten gains, prejudgment interest, and a civil money penalty to be determined by the Court upon motion by the Commission.

4. The Commission's complaint alleged, among other things, that Bercoon participated in a fraudulent securities offering pursuant to which at least $3.2 million was raised from at least 110 investors nationwide, from mid-2009 through the present. Investors were cold-called and offered and sold shares in L.A. Digital Post, Inc. ("L.A. Digital"), a television and film production company with offices in Los Angeles and New York, purportedly to grow the business of L.A. Digital. Bercoon directly and indirectly falsely told investors that L.A. Digital would conduct an initial public offering of its stock within two to six months, and that its shares would

soon trade on the New York Stock Exchange or the American Stock Exchange. In fact, Bercoon and others employed a "bait-and-switch" scheme whereby purchasers of the shares received stock certificates stating that they own shares in LADP, rather than in L.A. Digital. No public offering of L.A. Digital stock has occurred. Moreover, Bercoon has not distributed any monies raised in the LADP offering to L.A. Digital. Instead, Bercoon, who is one of the individuals who controls LADP's bank accounts, participated in the misappropriation for his and his co-defendant's own use and the use of other companies they control of at least $874,289 of the $3.2 million in investor funds raised.

IV.

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

Accordingly, it is hereby ORDERED, effective immediately, that Bercoon is suspended from appearing or practicing before the Commission as an attorney or accountant.

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
Release No. 64190 / April 5, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3260 / April 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14323

In the Matter of MICHAEL C. PATTISON, CPA Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS AND IMPOSING TEMPORARY SUSPENSION PURSUANT TO RULE 102(e)(3) OF THE COMMISSION'S RULES OF PRACTICE

I.

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

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

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

II.

The Commission finds that:

A. RESPONDENT

1. Pattison, age 46, is and has been a certified public accountant ("CPA") licensed to practice in the State of California. From January 2000 to July 2005, Respondent served as the Controller of Embarcadero Technologies, Inc. ("Embarcadero"), a San Francisco software company. Prior to joining Embarcadero, from 1987 until 1998, Respondent worked as an accountant at a series of San Francisco accounting firms.

B. CIVIL INJUNCTION

2. On February 23, 2011, the United States District Court for the Northern District of California entered an amended final judgment against Respondent. *SEC v. Pattison*, C-08-4238 EMC (N.D. Cal.). The final judgment, as amended, followed a jury trial in which the jury found that Respondent violated Section 13(b)(5) of the Securities and Exchange Act of 1934 ("Exchange Act"), and Exchange Act Rule 13b2-1.

3. The final judgment, as amended, among other things, permanently enjoins Respondent from future violations, direct or indirect, of Section 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1. It also requires Respondent to pay disgorgement, including prejudgment interest thereon, in the total amount of $74,446, and to pay a civil penalty in the amount of $50,000.

4. The Commission's complaint alleged, among other things, that from at least 2000 through 2005, Respondent intentionally falsified numerous books, records, and accounts in connection with the backdating of stock options granted to Embarcadero's employees. It further alleged that Respondent knowingly circumvented Embarcadero's internal accounting controls in order to avoid recording compensation expenses related to the backdated, in-the-money stock options, during the same time period.

III.

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64218 / April 6, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29624 / April 6, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14324

In the Matter of **Capital Financial Services, Inc. and Brian W. Boppre** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Capital Financial Services, Inc. ("Capital Financial") and Brian W. Boppre ("Boppre") (collectively "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Capital Financial is a wholly owned subsidiary of Capital Financial Holdings, Inc., and has been registered with the Commission and a member of the NASD (now FINRA) since 1980. Capital Financial operates as a general securities broker-dealer and is headquartered in Minot, North Dakota. Capital Financial has a network of

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approximately 273 offices housing over 332 registered representatives. The majority of Capital Financial's revenue is generated from the sale of mutual funds, variable insurance products, and private placements.

2. Boppre, age 47, was the president and a registered principal at Capital Financial until July 2010. Boppre resides in Minot, North Dakota.

B. OTHER RELEVANT ENTITIES AND INDIVIDUALS

1. Provident Royalties, LLC ("Provident") was a Delaware limited liability company with its principal offices in Dallas, Texas. Provident purportedly invested in oil and gas extraction interests through a group of 23 affiliated entities (collectively the "Provident Rule 506 Entities"). Provident is a beneficial owner in each of the Provident Rule 506 Entities. On June 22, 2009, Provident and 26 affiliated entities filed a voluntary petition for Chapter 11 bankruptcy in the United States Bankruptcy Court for the Northern District of Texas. Provident is currently in receivership

2. Provident Asset Management, LLC ("PAM") was a Delaware limited liability company which was registered with the Commission as a broker-dealer since March 9, 2004. PAM was the managing broker-dealer for the Provident offerings and exclusively sold the Provident Rule 506 Entity offerings. Capital Financial entered into a selling agreement with PAM for each Provident offering. FINRA expelled PAM from membership on March 18, 2010. PAM is currently in receivership.

3. Provident Rule 506 Entities ("Provident offerings") were a series of companies which have effected private placements claiming exemption from registration of the offered securities under Rule 506 of Regulation D. The offerings sold by Capital Financial included the following companies: Provident Energy 1, LP; Provident Energy 2, LP; Provident Energy 3, LP; Shale Royalties II, Inc.; Shale Royalties 3, LLC; Shale Royalties 4, Inc.; Shale Royalties 5, Inc.; Shale Royalties 6, Inc.; Shale Royalties 7, Inc.; Shale Royalties 9, Inc.; Shale Royalties 12, Inc.; Shale Royalties 14, Inc.; Shale Royalties 17, Inc.; Shale Royalties 18, Inc. The entities are headquartered in Provident's offices in Dallas, Texas. All the Provident Entities are controlled by a court-appointed receiver.

4. Jeffrey A. Lindsey, age 47, was a senior vice president and due diligence officer at Capital Financial until June 15, 2010. Lindsey resides in Libertyville, Illinois.

C. FAILURE TO CONDUCT A REASONABLE INVESTIGATION OF THE PROVIDENT OFFERINGS

1. From at least September 2006 through January 2009, Capital Financial marketed and sold Provident preferred stock and limited partnership interests in a series of 14 private placements. The Provident offerings each claimed an exemption from

registration of its offering pursuant to Rule 506 of Regulation D of the federal securities laws. The Provident offerings designated as Shale Royalties, Inc., numbered II through 18, offered two series of non-convertible redeemable cumulative preferred stock, while the offerings designated as Provident Energy, LP, numbered 1 through 3 offered limited partnership interests. The promised return on the Provident offerings was between 15%-18% per year depending on the term.

2. Provident Royalties' purported business plan included the acquisition of a combination of producing and non-producing sub-surface oil and gas mineral interests, working interests and real property located within the United States. According to the Provident offerings' Private Placement Memoranda ("PPM"), selling broker-dealers were paid commissions ranging from 5% to 9%. The sales commission varied by the offering, and by share class, with the longer term, Class A share class, paying a larger sales commission. Each PPM, with the exception of Provident Energy 1 and Provident Energy 3, disclosed that the selling broker-dealer would be paid a 1% due diligence fee in addition to the sales commission.

3. Although a portion of the proceeds of the Provident offerings were used for the acquisition and development of oil and gas activities, millions of dollars of investor funds were transferred from the later Provident offerings' bank accounts to the Provident Royalties' operating account and then used for undisclosed and, often, undocumented loans to earlier Provident offerings. The loan proceeds were then used to pay dividends and returns of capital to investors in earlier Provident offerings in a classic Ponzi scheme.

4. Capital Financial's due diligence process was run by Boppre and Lindsey. Boppre was responsible for reviewing new offerings and had the authority to approve the Provident offerings for Capital Financial.

5. Capital Financial was first introduced to Provident during the summer of 2006 by Darren Gibson ("Gibson"), a Provident wholesaler employed by PAM. Gibson provided Lindsey with a Provident PPM and other offering materials. Lindsey had no experience or background in the oil and gas industry.

6. On August 24, 2006, PAM paid Lindsey's expenses to conduct an on-site "due diligence" visit to Provident's Dallas offices. While at Provident, Lindsey met with Provident's principals, Gibson, various Provident land men, and a Provident geologist. The meeting consisted of a presentation of Provident's business plan, followed by a question and answer session. Lindsey also took a tour of the Provident offices. Lindsey did not receive any financial information or review any of the books or records of Provident during his visit. Boppre reviewed the materials provided to Capital Financial by Provident.

7. On September 20, 2006, Capital Financial signed its first selling agreement with PAM for Shale Royalties, II ("Shale II"). Lindsey and Boppre approved Shale II based on the offering materials received from PAM, Lindsey's on-site visit, and

the knowledge that other broker-dealers were selling the Provident offerings. Although Boppre and Lindsey eventually approved fourteen Provident offerings for sale by Capital Financial, Lindsey only visited Provident on two occasions.

8. Capital Financial never conducted independent verification of any of the offering materials provided by Provident. Capital Financial also never received audited or even unaudited financial statements for any of the Provident offerings. The only financial information Capital Financial received regarding Provident was an unaudited consolidated balance sheet review. However, even the unaudited consolidated balance sheet reviews were not included in the materials Capital Financial received until Shale Royalties 9. Capital Financial received this limited financial information after it approved the sale of the Provident offerings covered in those reports.

9. As each Provident offering became fully subscribed, Capital Financial signed selling agreements with PAM for later Provident offerings. In total, Capital Financial sold fourteen different Provident offerings between September 2006 and January 26, 2009 when Provident suspended sales. Lindsey and Boppre approved each Provident offering for sale by Capital Financial registered representatives.

10. Capital Financial registered representatives placed approximately 1,087 Provident trades for roughly $63,000,000. Capital Financial was typically paid an 8% sales commission plus a 1% due diligence fee on the amount of subscription proceeds. This resulted in Capital Financial receiving over $5,000,000 in sales commissions, and over $600,000 in due diligence fees on the Provident offerings.

11. Capital Financial's due diligence process for each successive Provident offering was similar to the process for Shale II. For each new Provident offering, Capital Financial received a due diligence packet from PAM. The packet typically contained: a lead broker-dealer bio, certificate of insurance, PPM, certificate of incorporation, corporate bylaws, prior activities, escrow agreement, investor subscription agreement, managing broker-dealer agreement, soliciting broker-dealer agreement, Form D, news articles, general industry geology reports regarding U.S. shale plays, sample mineral deed, and contact information. Lindsey did not visit Provident before approving each successive Provident offering. Capital Financial did not receive information from any other source before approving any Provident offering.

12. To assist with promoting the Provident offerings, PAM retained the third-party due diligence law firm Mick & Associates, PC ("Mick") to draft a third-party due diligence report ("Mick report") on each Provident offering. Provident paid all fees for the due diligence reports. Upon request, Mick reports were provided at no cost to Capital Financial. Mick reports were available on all Provident offerings.

13. Capital Financial's due diligence process did not require a Mick report or any other third-party due diligence prior to approving a Provident offering. Capital Financial only requested Mick reports on eight of the fourteen offerings it sold, and all eight of those Mick reports were requested by Capital Financial only after it had already

approved and started selling the offering. Boppre did not review any Mick reports prior to approving Provident offerings for sale by Capital Financial.

14. The PPM's for all of the Provident offerings disclosed that the selling broker-dealer would receive a due diligence fee of 1%. However, Capital Financial failed to disclose to investors that it did not spend any of the 1% due diligence fee conducting due diligence. Although it received over $600,000 for due diligence fees on the fourteen Provident offerings, Capital Financial incurred no due diligence expenses. At no time did Capital Financial hire independent counsel, an accounting firm, contact third parties regarding Provident's business, or hire consultants to review the Provident offerings.

15. Along with failing to conduct any meaningful due diligence with respect to the Provident offerings, Capital Financial also ignored significant red flags raised by Mick. The Mick reports beginning with Shale Royalties 9 issued in March 2008 raised concerns about Provident. The Shale Royalties 9 report highlighted Provident's lack of audited financial statements, and raised questions regarding conflicts of interest. The Mick report noted that the earlier Provident offerings were collectively reporting a net operating loss and the limited financial information lacked transparency.

16. Capital Financial failed to question these red flags brought up in the Mick reports with either Provident or Mick. After receiving the Shale 9 Mick report, Capital Financial sold an additional $32,000,000 of the Provident offerings. Capital Financial received and purportedly reviewed Mick reports for Shale Royalties 12 and Shale Royalties 18. Both reports raised the same red flags, only emphasizing those concerns by bolding or underlining the type. Although the Mick reports raised concerns about the Provident offerings, Capital Financial failed to provide its registered representatives with copies of these reports.

17. Capital Financial's due diligence responsibility was heightened by the fact that Provident was a relatively new company, Provident's management had very little experience in the oil and gas industry, Provident failed to produce audited or unaudited financial statements, and before Capital Financial entered into a sales agreement for the first time with Provident, Provident had only effected two prior offerings, both beginning in July 2006 involving a combined total of ten investors. Also, Provident paid a high dividend, and was a very risky investment.

18. Capital Financial failed to disclose to customers that although it was collecting a due diligence fee, it was not conducting due diligence. Customers believed that Capital Financial had thoroughly vetted the Provident offerings, and that Capital Financial was collecting a fee for the purpose of actually conducting due diligence before offering the securities to the public. Failure to disclose to its customers that it was collecting hundreds of thousands of dollars in due diligence fees while failing to conduct any due diligence constitutes a material omission.

19. Lindsey and Boppre knew that the Provident offering materials stated that selling broker-dealers would receive a 1% fee to pay for due diligence. This disclosure to investors suggested that Capital Financial conducted independent due diligence in approving the Provident offerings as appropriate to sell to Capital Financial customers. However, Capital Financial did not perform any independent due diligence.

20. Lindsey and Boppre knew Capital Financial failed to perform adequate due diligence before approving Provident for sale. Lindsey and Boppre knew they were relying exclusively on Provident for doing their due diligence. Instead, Lindsey and Boppre allowed Capital Financial registered representatives to pass on false representations to customers that Capital Financial was conducting due diligence on each provident offering. Customers were not told that although Capital Financial was paid over $630,000 in due diligence fees, it conducted no independent due diligence.

21. Lindsey and Boppre acted at least with severe recklessness. The duty to investigate was heightened by the fact that Provident was a relatively new company operated by individuals with little or no experience in the field of oil and gas, lacked audited financial statements, and promised high returns. Lindsey and Boppre approved Provident offerings without obtaining third-party Mick reports, and failed to question red flags brought to their attention through the few Mick reports received.

D. VIOLATIONS

1. As a result of the conduct described above, Respondents committed violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities

III.

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

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

B. What, if any, remedial action is appropriate in the public interest against Boppre pursuant to Section 15(b)(6) of the Exchange Act and 9(b) of the Investment Company Act, including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Capital Financial pursuant to Section 15(b)(4) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

D. Whether, pursuant to Section 21C of the Exchange Act Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IV.

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

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

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

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

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

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

By the Commission.

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 EXCHANGE ACT OF 1934
Release No. 64219 / April 6, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29625 / April 6, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14325

In the Matter of **Jeffrey A. Lindsey,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Jeffrey A. Lindsey ("Respondent" or "Lindsey").

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

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

These proceedings arise out of Capital Financial Services, Inc.'s failure to perform reasonable due diligence on numerous private placement offerings prior to recommending them to customers where the offerings turned out to be a classic Ponzi scheme and offering fraud.

Respondent

1. Respondent was a senior vice president and due diligence officer at Capital Financial Services, Inc. ("Capital Financial"), a broker-dealer registered with the Commission, until June 15, 2010. From May 1, 2002 through June 15, 2010, Respondent was also a registered representative associated with Capital Financial. Respondent, 47 years old, is a resident of Libertyville, Illinois.

Other Relevant Entities

2. Capital Financial is a wholly owned subsidiary of Capital Financial Holdings, Inc., and has been registered with the Commission and a member of the NASD (now FINRA) since 1980. Capital Financial operates as a general securities broker-dealer and is headquartered in Minot, North Dakota. Capital Financial has a network of approximately 273 offices housing over 332 registered representatives. The majority of Capital Financial's revenue is generated from the sale of mutual funds, variable insurance products, and private placements.

3. Provident Royalties, LLC ("Provident") was a Delaware limited liability company with its principal offices in Dallas, Texas. Provident purportedly invested in oil and gas extraction interests through a group of 23 affiliated entities (collectively the "Provident Rule 506 Entities"). Provident is a beneficial owner in each of the Provident Rule 506 Entities. On June 22, 2009, Provident and 26 affiliated entities filed a voluntary petition for Chapter 11 bankruptcy in the United States Bankruptcy Court for the Northern District of Texas. Provident is currently in receivership.

4. Provident Asset Management, LLC ("PAM") was a Delaware limited liability company which was registered with the Commission as a broker-dealer since March 9, 2004. PAM was the managing broker-dealer for the Provident offerings and exclusively sold the

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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.

Provident Rule 506 Entity offerings. Capital Financial entered into a selling agreement with PAM for each Provident offering in which Capital Financial participated as a selling broker-dealer. FINRA expelled PAM from membership on March 18, 2010. PAM is currently in receivership.

5. Provident Rule 506 Entities ("Provident offerings") were a series of companies which have effected private placements claiming exemption from registration of the offered securities under Rule 506 of Regulation D. The offerings sold by Capital Financial included the following companies: Provident Energy 1, LP; Provident Energy 2, LP; Provident Energy 3, LP; Shale Royalties II, Inc.; Shale Royalties 3, LLC; Shale Royalties 4, Inc.; Shale Royalties 5, Inc.; Shale Royalties 6, Inc.; Shale Royalties 7, Inc.; Shale Royalties 9, Inc.; Shale Royalties 12, Inc.; Shale Royalties 14, Inc.; Shale Royalties 17, Inc.; Shale Royalties 18, Inc. The entities are headquartered in Provident's offices in Dallas, Texas. All the Provident Entities are controlled by a court-appointed receiver.

Background

6. From at least September 2006 through January 2009, Capital Financial marketed, recommended to investors, and sold Provident preferred stock and limited partnership interests in a series of 14 private placements. The Provident offerings each claimed an exemption from registration of its offering pursuant to Rule 506 of Regulation D of the federal securities laws. The Provident offerings designated as Shale Royalties, Inc., numbered II through 18, offered two series of non-convertible redeemable cumulative preferred stock, while the offerings designated as Provident Energy, LP, numbered 1 through 3, offered limited partnership interests. The promised return on the Provident offerings was between 15%-18% per year depending on the term.

7. Provident Royalties' purported business plan included the acquisition of a combination of producing and non-producing sub-surface oil and gas mineral interests, working interests and real property located within the United States. According to the Provident offerings' Private Placement Memoranda ("PPM"), selling broker-dealers were paid commissions ranging from 5% to 9%. The sales commission varied by the offering, and by share class, with the longer term, Class A share class, paying a larger sales commission. Each PPM, with the exception of Provident Energy 1 and Provident Energy 3, disclosed that the selling broker-dealer would be paid a 1% due diligence fee in addition to the sales commission.

8. Although a portion of the proceeds of the Provident offerings were used for the acquisition and development of oil and gas activities, millions of dollars of investor funds were transferred from the later Provident offerings' bank accounts to the Provident Royalties' operating account and then used for undisclosed and, often, undocumented loans to earlier Provident offerings. The loan proceeds were then used to pay dividends and returns of capital to investors in earlier Provident offerings in a classic Ponzi scheme.

9. Lindsey participated in Capital Financial's due diligence process. Lindsey was responsible for reviewing the Provident new offerings and had the authority to approve the Provident offerings for Capital Financial to recommend to its customers. Lindsey received

assistance conducting due diligence from Brian Boppre ("Boppre"), initially Chief Operating Officer and later President (November of 2008) at Capital Financial.

10. Capital Financial was first introduced to Provident during the summer of 2006 by Darren Gibson ("Gibson"), a Provident wholesaler employed by PAM. Gibson provided Lindsey with a Provident PPM and other offering materials. Lindsey had no direct experience or background in the oil and gas industry.

11. On August 24, 2006, PAM paid Lindsey's expenses to conduct an on-site "due diligence" visit to Provident's Dallas offices. While at Provident, Lindsey met with Provident's principals, Gibson, various Provident land men, and a Provident geologist. The meeting consisted of a presentation of Provident's business plan, followed by a question and answer session. Lindsey also took a tour of the Provident offices. Lindsey did not receive any financial statement information or review any of the books or records of Provident during his visit.

12. On September 20, 2006, Capital Financial signed its first selling agreement with PAM for Shale Royalties, II ("Shale II"). Lindsey and Boppre approved Shale II based on the offering materials received from PAM, Lindsey's on-site visit, and the knowledge that other broker-dealers were selling the Provident offerings. Lindsey visited Provident twice during the selling period and eventually approved fourteen Provident offerings for Capital Financial to recommend and sell to its customers.

13. Capital Financial never independently investigated any of the information in the offering materials provided by Provident. Capital Financial also never received audited or even unaudited financial statements for any of the Provident offerings. The only financial information Capital Financial received regarding Provident was an unaudited consolidated balance sheet review. However, even the unaudited consolidated balance sheet reviews were not included in the materials Capital Financial received until Shale Royalties 9. Capital Financial received this limited financial information after it approved the sale and recommendation to investors of the Provident offerings covered in those reports.

14. As each Provident offering became fully subscribed, Capital Financial signed selling agreements with PAM for later Provident offerings. In total, Capital Financial recommended and sold fourteen different Provident offerings between September 2006 and January 26, 2009 when Provident suspended sales. Lindsey and Boppre approved each Provident offering for sale by Capital Financial registered representatives to recommend and sell to Capital Financial customers.

15. Capital Financial registered representatives placed approximately 1,087 Provident trades for roughly $63,000,000. Capital Financial was typically paid an 8% sales commission plus a 1% due diligence fee on the amount of subscription proceeds. This resulted in Capital Financial receiving over $5,000,000 in sales commissions, and over $600,000 in due diligence fees on the Provident offerings.

16. Capital Financial's due diligence process for each successive Provident offering was similar to the process for Shale II. For each new Provident offering, Capital Financial received a due diligence packet from PAM. The packet typically contained: a lead broker-dealer bio, certificate of insurance, PPM, certificate of incorporation, corporate bylaws, prior activities, escrow agreement, investor subscription agreement, managing broker-dealer agreement, soliciting broker-dealer agreement, Form D, news articles, general industry geology reports regarding U.S. shale plays, sample mineral deed, and contact information. Lindsey visited Provident's offices twice in the sales period but did not visit Provident before approving each successive Provident offering. Capital Financial did not receive information from any other source before approving any Provident offering.

17. To assist with promoting the Provident offerings, PAM retained the third-party due diligence law firm Mick & Associates, PC ("Mick") to draft a third-party due diligence report ("Mick report") on each Provident offering. Provident paid all fees for the due diligence reports. Upon request, Mick reports were provided at no cost to Capital Financial.

18. Capital Financial's due diligence process did not require a Mick report or any other third-party due diligence prior to approving a Provident offering even though neither Lindsey nor Boppre had experience in the oil and gas industry. Capital Financial only requested Mick reports on eight of the fourteen offerings it sold, and all eight of those Mick reports were received by Capital Financial only after it had already approved and started recommending and selling the offering.

19. The PPM's for all of the Provident offerings disclosed that the selling broker-dealer would receive a due diligence fee of 1%. However, Capital Financial did not disclose to investors that it did not spend the 1% due diligence fee conducting due diligence. Although it received over $600,000 for due diligence fees on the fourteen Provident offerings, Capital Financial incurred no direct due diligence expenses. At no time did Capital Financial hire independent counsel, an accounting firm, contact third parties regarding Provident's business, or hire consultants to review the Provident offerings.

20. Along with failing to conduct any due diligence with respect to the Provident offerings, prior to recommending them to investors, Capital Financial also did not act upon issues raised by Mick. The Mick reports beginning with Shale Royalties 9 issued in March 2008 raised concerns about Provident. The Shale Royalties 9 report highlighted Provident's lack of audited financial statements, and raised questions regarding conflicts of interest. The Mick report noted that the earlier Provident offerings were collectively reporting a net operating loss and the limited financial information lacked transparency.

21. Capital Financial did not question issues brought up in the Mick reports with either Provident or Mick. After receiving the Shale 9 Mick report, Capital Financial recommended and sold an additional $32,000,000 of the Provident offerings. Capital Financial received and purportedly reviewed Mick reports for Shale Royalties 12 and Shale Royalties 18. Both reports raised the same issues, only emphasizing those concerns by bolding or underlining the type. Although the Mick reports raised concerns about the Provident offerings, Capital Financial did not

provide its registered representatives with copies of these reports unless the representative requested the reports and Capital Financial did not take steps to address whether this information was disclosed to customers.

22. Capital Financial's due diligence responsibility was heightened by the fact that Provident was a relatively new company, Provident's management had limited experience in the oil and gas industry, Provident did not produce audited or unaudited financial statements, and before Capital Financial entered into a sales agreement for the first time with Provident, Provident had only effected two prior offerings, both beginning in July 2006 involving a combined total of ten investors. Provident paid a high dividend, and was a risky investment as was stated in the PPM.

23. Capital Financial did not disclose to customers that although it was collecting a due diligence fee, it was not conducting any outside due diligence.

24. Lindsey knew that the Provident offering materials stated that selling broker-dealers would receive a 1% due diligence fee. This disclosure to investors suggested that Capital Financial conducted independent due diligence in approving the Provident offerings as appropriate to recommend and sell to Capital Financial customers. However, Capital Financial did not perform any independent due diligence.

25. Lindsey knew Capital Financial did not perform independent due diligence before approving Provident for sale. Lindsey knew they were relying exclusively on Provident for doing their due diligence. Customers were not told that although Capital Financial was paid over $630,000 in due diligence fees, it conducted no independent due diligence.

26. Lindsey acted at least with severe recklessness. The duty to investigate was heightened by the fact that Provident was a relatively new company operated by individuals with little experience in the field of oil and gas, lacked audited financial statements, and promised high returns. Lindsey approved Provident offerings without obtaining third-party Mick reports in advance of approval, and did not act on issues brought to their attention through the few Mick reports received.

27. As a result of the conduct described above, Lindsey willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase, or sale of securities.

Undertakings

Respondent Lindsey undertakes to:

28. Provide to the Commission, within 30 days after the end of the two-year bar period described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act and Section 9(b) of the Investment Company Act it is hereby ORDERED that:

A. Respondent Lindsey 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 Lindsey be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, and barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock, with the right to apply for reentry after two (2) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

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.

D. Respondent shall pay a civil money penalty in the amount of $25,000 to the United States Treasury. Payment shall be made in the following installments: $5,000 within 10 days of the entry of this Order, and three payments of $5,000 every 90 days thereafter with one final fourth payment of $5,000 to be made on the one-year anniversary of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of the civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payments shall be: (A) made by 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 Jeffrey A. Lindsey as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and wire transfer, money order or check shall be sent to Karen L. Martinez, Division of Enforcement, Securities and Exchange Commission, 15 W. South Temple, Suite 1800, Salt Lake City, UT 84101.

E. Respondent shall comply with the undertakings enumerated in paragraph 28 above.

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

SECURTIES EXCHANGE ACT OF 1934
Release No. 64221 / April 7, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14326

In the Matter of	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**
Frederick O. Kraus,	
Respondent.	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Frederick O. Kraus ("Kraus" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that[1]:

Summary

These proceedings arise out of violations by GunnAllen Financial, Inc. ("GunnAllen"), formerly a Tampa, Florida-based broker-dealer, of Regulation S-P which governs the privacy and protection of consumer financial information. Between March and June 2010, as it was winding down its business operations and planned to file for bankruptcy, GunnAllen's president, Kraus, authorized the transfer of approximately 16,000 direct application accounts to GunnAllen's National Sales Manager (the "Sales Manager"), and any broker-dealer with whom the Sales Manager affiliated. Direct application accounts are those accounts held by the product issuer, typically a mutual fund or insurance company.

On or before April 23, 2010, when the Sales Manager accepted employment with a new broker-dealer and resigned from GunnAllen, he downloaded nonpublic customer information for the 16,000 accounts on a portable thumb drive. Two weeks after joining the new broker-dealer, the Sales Manager mailed a letter (its content was previously reviewed and approved by Kraus), on GunnAllen letterhead notifying the account holders that GunnAllen could no longer service the accounts, that he and his business partner were servicing the accounts, and advising them of their right to "opt out" of the transfer. This after the fact notice failed to provide customers with a reasonable opportunity to opt out of the transfer because, among other things, it did not provide procedures on how to exercise that right, contact information or even the identity of the new broker-dealer. Thereafter, the Sales Manager supplied the broker-dealer receiving the accounts with nonpublic personal information for the 16,000 accounts, including the product custodian, the account holder's name and address, and the account number and value for each account.

GunnAllen's transfer of this nonpublic information without providing its customers reasonable notice to opt out violated Rule 10(a)(1) of Regulation S-P (17 C.F.R. §248.10(a)(1)), which prohibits broker-dealers from disclosing nonpublic personal information they collect from customers to nonaffiliated third parties unless they notify their customers of their right to opt out of the disclosure in accordance with Rule 7(a) of Regulation S-P (17 C.F.R. §248.7(a)), and they provide their customers with a reasonable opportunity to opt out of the disclosure. The customer information was also transferred to the Sales Manager, and thereafter, the receiving broker, in a manner that placed the information at substantial risk of unauthorized access and use in contravention of GunnAllen's obligation to ensure the security and confidentiality of the information as required by Rule 30(a) of Regulation S-P (the "Safeguard Rule") (17 C.F.R. §248.30(a)). As a result, Kraus aided and abetted and caused GunnAllen's violations of Rules 7(a), 10(a) and 30(a) of Regulation S-P.

Respondent

[1] The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other persons or entities in this or any other proceeding.

1. Kraus, age 56, resides in St. Petersburg, Florida. From September 2009 to September 2010, Kraus served as President of GunnAllen. Kraus also served as GunnAllen's Chief Financial Officer from October 2008 to September 2010, and the firm's Director of Supervision from January 2005 to August 2009.

GunnAllen Financial, Inc.

2. GunnAllen had a principal place of business in Tampa, Florida and was registered with the Commission as a broker-dealer from March 1986 to April 2010. The firm operated mostly under an independent contractor model and maintained franchise offices nationwide. In March 2010, the Financial Industry Regulatory Authority (FINRA) determined that GunnAllen did not have the requisite net capital to conduct business as a broker-dealer and restricted its operations to liquidating securities transactions. Unable to raise the additional capital it needed to continue to conduct business, in April 2010 GunnAllen discontinued its operations, filed for bankruptcy, and submitted a Broker-Dealer Withdrawal, or "BDW", Form with the Commission withdrawing its registration. The withdrawal became effective on June 11, 2010.

The Account Transfers

3. As it was winding down its business operations in March and April 2010, GunnAllen and its registered representatives transferred the firm's customer accounts to other broker-dealers. In addition to servicing the brokerage accounts held by its clearing firm, GunnAllen serviced and was the broker of record on tens of thousands of direct application accounts held by various mutual fund and variable annuity and insurance companies. As broker of record on the direct application accounts, GunnAllen was entitled to the commissions, trailers and other fees generated by the accounts.

4. On March 28, 2010, GunnAllen sent a letter, drafted by the Sales Manager but reviewed and approved by Kraus, to all of the firm's direct application account customers notifying them that it expected to cease operations on March 31, 2010 (the "First Notice"). The First Notice instructed customers that they had three options for arranging ongoing service of their accounts: (i) they could contact their GunnAllen registered representative to make arrangements to transfer their account to the new firm with which he or she associated, (ii) they could contact a brokerage firm of their own choice and request their account be transferred to that firm, or (iii) they could contact the mutual fund or variable annuity or insurance company holding their investment directly to make arrangements for service.

5. However, on March 30, 2010, just two days after GunnAllen sent the First Notice, Kraus authorized the transfer of approximately 16,000 direct application accounts serviced by GunnAllen to the Sales Manager. Kraus executed "*Block Broker-Dealer Change Authorization for Directly Held Accounts*" forms (the "Block Transfer Forms") covering those accounts and gave the signed Block Transfer Forms to the Sales Manager and another GunnAllen representative with whom the Sales Manager planned to form a business partnership when GunnAllen ceased doing business. By signing the Block Transfer Forms and turning them over to the Sales Manager and his partner, Kraus authorized the transfer of the 16,000 accounts to any

broker-dealer that the Sales Manager and his partner chose to associate with after they left GunnAllen.

6. In April 2010, while assisting Kraus in the wind down of GunnAllen's business operations, the Sales Manager and his partner sought employment with other brokerage firms by offering, among other things, to transfer to them the direct application accounts for which they held the Block Transfer Forms. On April 23, 2010, they were hired by another broker-dealer registered with the Commission (the "Receiving Broker"). The Sales Manager and his partner agreed to share 10% of the commissions, trailers and other fees generated by the accounts with the Receiving Broker and to solicit the account holders to purchase additional products from the Receiving Broker. On that same day, the Sales Manager resigned from GunnAllen.

7. On April 23, 2010, or shortly before then, the Sales Manager downloaded a spreadsheet from a GunnAllen computer server or drive to a personal thumb drive and physically removed it from the firm. The spreadsheet contained the custodian, account holder's name and address, account number and value of the approximately 16,000 direct application accounts covered by the Block Transfer Forms authorized by Kraus. The spreadsheet indicated that the direct application accounts included therein, in the aggregate, had a stated but not confirmed estimated total value of $850 million as of March 23, 2010.

8. Two weeks after associating with the Receiving Broker, on May 14, 2010, the Sales Manager sent the GunnAllen customers holding the direct application accounts a letter notifying them that their accounts would be transferred to the brokerage firm he was newly associated with unless they objected to the transfer within fifteen days of the date of the letter (the "Second Notice"). Although the Sales Manager drafted and personally paid for the cost of copying and mailing the letter, its content was reviewed and approved previously by Kraus, and it was sent on GunnAllen letterhead. The Sales Manager engaged a third party vendor to copy and mail the Second Notice on his behalf and supplied it with the customer names and addresses he took from GunnAllen on his thumb drive.

9. After mailing the Second Notice, the Sales Manager contacted GunnAllen to see if it had received notices from any customers seeking to opt out of the account transfer, but did not take any other steps to verify customer objections to the transfer and, thereafter, e-mailed the Receiving Broker the customer account information that he had taken from GunnAllen on his thumb drive. His partner also supplied the Receiving Broker with the Block Transfer Forms signed by Kraus.

10. Beginning on June 3, 2010, and continuing through at least June 7, 2010, the Receiving Broker counter-signed the Block Transfer Forms accepting the direct application accounts from GunnAllen. It also delivered the fully executed forms to the appropriate mutual fund and variable annuity and insurance companies along with a letter instructing them to change the broker of record on the direct application accounts from GunnAllen to the Receiving Broker.

Violations of the Privacy Rules

11. Rule 10(a) of Regulation S-P prohibits brokers and dealers, either directly or through an affiliate, from disclosing nonpublic personal information about their customers to nonaffiliated third parties unless they have provided their customers with a privacy notice describing the nonpublic personal information they disclose, and notify their customers of their right to opt out of any disclosure and afford them a reasonable opportunity to opt out of the disclosure before it is made.

12. Rule 7(a) of Regulation S-P requires brokers and dealers to provide their customers with opt out notices that are clear and conspicuous and that accurately explain customers' opt out rights. The notice must explicitly state that the broker or dealer discloses, or reserves the right to disclose, nonpublic personal information about its customers and that they have the right to opt out of any disclosure. Additionally, the notice must provide a reasonable means by which customers can exercise their right to opt out.

13. GunnAllen violated Rules 7(a) and 10(a) of Regulation S-P by failing to provide the direct application account customers whose accounts were transferred to the Receiving Broker with proper notice and a reasonable opportunity to opt out of the transfer before supplying their personal nonpublic information to the Sales Manager and the Receiving Broker. Also, GunnAllen's disclosure of the information was not covered by any exception from Regulation S-P's notice and opt out requirements, including an exception in Rule 14 of Regulation S-P for disclosures that are required, or are a usual, appropriate, or acceptable method, in connection with the transfer of accounts, because GunnAllen failed to obtain the customers' affirmative consent to transfer the direct applications accounts. The First and Second Notices failed to inform account holders that GunnAllen would physically transfer or, in the case of the Second Notice, had physically transferred, their account information. The Second Notice also failed to provide account holders with a reasonable means to exercise their right to opt out of the transfer, or sufficient time within which to do so. Further, the direct application account customers were not provided with a paper or electronic form to object to the transfer although Rule 7(a)(2)(iii) of Regulation S-P expressly states it is unreasonable "if the only means of opting out is for the consumer to write his or her own letter to exercise the opt out right." Finally, the Second Notice provided only fifteen days to opt out of the transfer although the circumstances did not warrant such a short response period.

14. As a result of the conduct described above, Kraus willfully aided and abetted and caused GunnAllen's violations of Rules 7(a) and 10(a) of Regulation S-P under the Exchange Act.

Violations of the Safeguard Rule

15. Rule 30(a) of Regulation S-P, or the Safeguard Rule, requires every broker and dealer to maintain policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. The policies and procedures must be reasonably designed to (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity

of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

16. GunnAllen violated Rule 30(a) of Regulation S-P because it knew that there was a reasonably foreseeable risk that its departing registered representatives would disclose customer nonpublic personal information to successor brokerage firms but nonetheless failed to adopt, and did not have in place while winding down its operations, any written policies or procedures addressing the transfer and protection of such information.

17. As president of GunnAllen, Kraus was familiar with Regulation S-P and GunnAllen's responsibilities under the rule for maintaining the confidentiality and physical security of the information that the firm collected from its customers. Nonetheless, he knowingly placed customer information at substantial risk of unauthorized access and misuse when he executed the Block Transfer Forms and authorized the Sales Manager to download customer information for approximately 16,000 GunnAllen direct application accounts to a personal thumb drive that he physically took from the firm.

18. As a result of the conduct described above, Kraus willfully aided and abetted and caused GunnAllen's violations of Rule 30(a) of Regulation S-P.

IV.

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

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

A. Respondent Kraus cease and desist from committing or causing any violations and any future violations of Rules 7(a), 10(a) and 30(a) of Regulation S-P under the Exchange Act.

B. Respondent Kraus is censured.

C. Respondent Kraus shall pay a civil money penalty of $20,000 to the United States Treasury. Payment shall be made in the following installments: $5,000 within 10 days of the entry of this Order; $5,000 within 90 days of the entry of this Order; $5,000 within 180 days of the entry of this Order; and $5,000 within 270 days of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of the civil penalty, plus any interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payments shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, or bank money order; (B) 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 Respondent's name as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and wire transfer, money order or check shall be sent to Teresa J. Verges, Assistant Regional Director, Miami Regional Office, Securities and Exchange Commission, 801 Brickell Avenue, Suite 1800, Miami, FL 33131.

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

SECURTIES EXCHANGE ACT OF 1934
Release No. 64222 / April 7, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14327

In the Matter of	:	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**
David C. Levine,	:	
Respondent.	:	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against David C. Levine ("Levine" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that[1]:

Summary

These proceedings arise out of violations by GunnAllen Financial, Inc. ("GunnAllen"), formerly a Tampa, Florida-based broker-dealer, of Regulation S-P which governs the privacy and protection of consumer financial information.' Between March and June 2010, as it was winding down its business operations and planned to file for bankruptcy, GunnAllen's president authorized the transfer of approximately 16,000 direct application accounts with an estimated total net asset value of $850 million to Levine, who then served as GunnAllen's National Sales Manager, and any broker-dealer with whom he became affiliated. Direct application accounts are those accounts held by the product issuer, typically a mutual fund or insurance company.

In connection with this transfer, and prior to resigning from GunnAllen, Levine downloaded nonpublic customer information for the 16,000 accounts on a portable thumb drive. Levine resigned from GunnAllen on April 23, 2010, and then affiliated with a new broker-dealer. Two weeks after joining the new broker-dealer, Levine mailed a letter, reviewed and approved by GunnAllen's president and on GunnAllen letterhead, notifying the 16,000 customers that GunnAllen could no longer service the accounts, that Levine and his business partner were servicing the accounts, and advising them of their right to "opt out" of the transfer. This letter failed to provide customers with a reasonable opportunity to opt out of the transfer because, among other things, it was sent after the customers' information was transferred to Levine and it did not provide procedures on how to exercise that right, contact information or even the identity of the new broker-dealer. Thereafter, Levine supplied the broker-dealer receiving the accounts with nonpublic personal information for the 16,000 accounts, including the product custodian, the account holder's name and address, and the account number and value for each account.

GunnAllen's transfer of this nonpublic information without providing its customers reasonable notice to opt out violated Rule 10(a)(1) of Regulation S-P (17 C.F.R. §248.10(a)(1)), which prohibits broker-dealers from disclosing nonpublic personal information they collect from customers to nonaffiliated third parties unless they notify their customers of their right to opt out of the disclosure in accordance with Rule 7(a) of Regulation S-P (17 C.F.R. §248.7(a)), and they provide their customers with a reasonable opportunity to opt out of the disclosure. Levine also took possession of the information in a manner that placed the information at risk of unauthorized access and use in contravention of GunnAllen's obligation to ensure the security and confidentiality of the information as required by Rule 30(a) of Regulation S-P (the "Safeguard Rule") (17 C.F.R. §248.30(a)). As a result, Levine aided and abetted and caused GunnAllen's violations of Rules 7(a), 10(a) and 30(a) of Regulation S-P.

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1 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other persons or entities in this or any other proceeding.

Respondent

1. Levine, age 44, resides in Delray Beach, Florida. From May 2005 to April 2010, Levine served as GunnAllen's National Sales Manager. Although he was employed with GunnAllen through the end of April 2010, on March 30, 2010, GunnAllen filed Forms U5 terminating the registrations of all its representatives, including Levine's.

GunnAllen Financial, Inc.

2. GunnAllen had a principal place of business in Tampa, Florida and was registered with the Commission as a broker-dealer from March 1986 to April 2010. The firm operated mostly under an independent contractor model and maintained franchise offices nationwide. In March 2010, the Financial Industry Regulatory Authority (FINRA) determined that GunnAllen did not have the requisite net capital to conduct business as a broker-dealer and restricted its operations to liquidating securities transactions. Unable to raise the additional capital it needed to continue to conduct business, in April 2010 GunnAllen discontinued its operations, filed for bankruptcy, and submitted a Broker-Dealer Withdrawal, or "BDW", Form with the Commission withdrawing its registration. The withdrawal became effective on June 11, 2010.

The Account Transfers

3. As it was winding down its business operations in March and April 2010, GunnAllen and its registered representatives transferred the firm's customer accounts to other broker-dealers. In addition to servicing the brokerage accounts held by its clearing firm, GunnAllen serviced and was the broker of record on tens of thousands of direct application accounts held by various mutual fund and variable annuity and insurance companies. As broker of record on the direct application accounts, GunnAllen was entitled to the commissions, trailers and other fees generated by the accounts.

4. On March 28, 2010, GunnAllen sent a letter, drafted by Levine and reviewed and approved by GunnAllen's president, to all of the firm's direct application account customers notifying them that it expected to cease operations on March 31, 2010 (the "First Notice"). The First Notice instructed customers that they had three options for arranging ongoing service of their accounts: (i) they could contact their GunnAllen registered representative to make arrangements to transfer their account to the new firm with which he or she associated, (ii) they could contact a brokerage firm of their own choice and request their account be transferred to that firm, or (iii) they could contact the mutual fund or variable annuity or insurance company holding their investment directly to make arrangements for service.

5. However, on March 30, 2010, just two days after GunnAllen sent the First Notice, at the request of Levine, GunnAllen's president authorized the transfer of approximately 16,000 direct application accounts serviced by GunnAllen, which had an estimated total net asset value of $850 million. GunnAllen's president executed "*Block Broker-Dealer Change Authorization for Directly Held Accounts*" forms (the "Block Transfer Forms") covering those accounts and gave the signed Block Transfer Forms to Levine and another GunnAllen representative with

whom Levine planned to form a business partnership when GunnAllen ceased doing business. The executed Block Transfer Forms authorized the transfer of the 16,000 accounts to any broker-dealer that Levine and his partner chose to associate with after they left GunnAllen.

6. In April 2010, while assisting in the wind down of GunnAllen's business operations, Levine and his partner sought employment with other brokerage firms by offering, among other things, to transfer to them the direct application accounts for which they held the Block Transfer Forms. On April 23, 2010, they were hired by another broker-dealer registered with the Commission (the "Receiving Broker"). Levine and his partner agreed to share 10% of the commissions, trailers and other fees generated by the accounts with the Receiving Broker and to solicit the account holders to purchase additional products from the Receiving Broker.

7. The same day that Levine was hired by the Receiving Broker, he resigned from GunnAllen. On April 23, 2010, or shortly before then, Levine, with the approval of GunnAllen's president, downloaded a spreadsheet from a GunnAllen computer server or drive to a personal thumb drive and physically removed it from the firm. The spreadsheet contained the custodian, account holder's name and address (but not his or her social security number), and account number and value for each of the approximately 16,000 direct application accounts covered by the Block Transfer Forms.

8. Two weeks after associating with the Receiving Broker, on May 14, 2010, Levine, with the approval of GunnAllen's president, sent the GunnAllen customers holding the direct application accounts a letter notifying them that their accounts would be transferred to the brokerage firm he was newly associated with unless they objected to the transfer within fifteen days of the date of the letter (the "Second Notice"). Levine drafted and personally paid for the cost of copying and mailing the Second Notice, which was on GunnAllen letterhead. Levine engaged a third party vendor to copy and mail the Second Notice on his behalf and supplied it with the customer names and addresses he took from GunnAllen on his thumb drive.

9. After mailing the Second Notice, Levine contacted GunnAllen to see if it had received notices from any customers seeking to opt out of the account transfer, but did not take any other steps to verify customer objections to the transfer and, thereafter, e-mailed the Receiving Broker the customer account information that had been released to him by GunnAllen on his thumb drive. Levine's partner supplied the Receiving Broker with the Block Transfer Forms.

10. Beginning on June 3, 2010, and continuing through at least June 7, 2010, the Receiving Broker counter-signed the Block Transfer Forms accepting the direct application accounts from GunnAllen. It also delivered the fully executed forms to the appropriate mutual fund and variable annuity and insurance companies along with a letter instructing them to change the broker of record on the direct application accounts from GunnAllen to the Receiving Broker.

Violations of the Privacy Rules

11. Rule 10(a) of Regulation S-P prohibits brokers and dealers, either directly or through an affiliate, from disclosing nonpublic personal information about their customers to nonaffiliated third parties unless they have provided their customers with a privacy notice describing the nonpublic personal information they disclose, and notify their customers of their right to opt out of any disclosure and afford them a reasonable opportunity to opt out of the disclosure before it is made.

12. Rule 7(a) of Regulation S-P requires brokers and dealers to provide their customers with opt out notices that are clear and conspicuous and that accurately explain customers' opt out rights. The notice must explicitly state that the broker or dealer discloses, or reserves the right to disclose, nonpublic personal information about its customers and that they have the right to opt out of any disclosure. Additionally, the notice must provide a reasonable means by which customers can exercise their right to opt out.

13. GunnAllen violated Rules 7(a) and 10(a) of Regulation S-P by failing to provide the direct application account customers whose accounts were transferred to the Receiving Broker with proper notice and a reasonable opportunity to opt out of the transfer before supplying their personal nonpublic information to Levine and the Receiving Broker. Also, GunnAllen's disclosure of the information was not covered by any exception from Regulation S-P's notice and opt out requirements, including an exception in Rule 14 of Regulation S-P for disclosures that are required, or are a usual, appropriate, or acceptable method, in connection with the transfer of accounts, because GunnAllen failed to obtain the customers' affirmative consent to transfer the direct applications accounts. The First and Second Notices failed to inform account holders that GunnAllen would physically transfer or, in the case of the Second Notice, had physically transferred, their account information. The Second Notice also failed to provide account holders with a reasonable means to exercise their right to opt out of the transfer, or sufficient time within which to do so. Further, the direct application account customers were not provided with a paper or electronic form to object to the transfer although Rule 7(a)(2)(iii) of Regulation S-P expressly states it is unreasonable "if the only means of opting out is for the consumer to write his or her own letter to exercise the opt out right." Finally, the Second Notice provided only fifteen days to opt out of the transfer although the circumstances did not warrant such a short response period.

14. As a result of the conduct described above, Levine willfully[2] aided and abetted and caused GunnAllen's violations of Rules 7(a) and 10(a) of Regulation S-P.

Violations of the Safeguard Rule

15. Rule 30(a) of Regulation S-P, or the Safeguard Rule, requires every broker and dealer to maintain policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. The policies and procedures

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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 *Huges v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949).

must be reasonably designed to (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

16. GunnAllen violated Rule 30(a) of Regulation S-P because it knew that there was a reasonably foreseeable risk that its departing registered representatives would disclose customer nonpublic personal information to successor brokerage firms but nonetheless failed to adopt, and did not have in place while winding down its operations, any written policies or procedures addressing the transfer and protection of such information.

17. As a senior officer of GunnAllen, Levine was familiar with Regulation S-P and GunnAllen's responsibilities under the rule for maintaining the confidentiality and physical security of the information that the firm collected from its customers. Nonetheless, he placed customer information at risk of unauthorized access and misuse when he knowingly downloaded customer information for approximately 16,000 GunnAllen direct application accounts to a personal thumb drive that he physically took from the firm.

18. As a result of the conduct described above, Levine willfully aided and abetted and caused GunnAllen's violations of Rule 30(a) of Regulation S-P.

IV.

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

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

A. Respondent Levine cease and desist from committing or causing any violations and any future violations of Rules 7(a), 10(a) and 30(a) of Regulation S-P.

B. Respondent Levine is censured.

C. Respondent Levine shall, within ten days of the entry of this Order, pay a civil money penalty of $20,000 to the United States Treasury. If timely payment is not made additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, or bank money order; (B) 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 Levine as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and wire transfer, money order or check shall be sent to Teresa J.

Verges, Assistant Regional Director, Miami Regional Office, Securities and Exchange Commission, 801 Brickell Avenue, Suite 1800, Miami, FL 33131.

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

SECURTIES EXCHANGE ACT OF 1934
Release No. 64220 / April 7, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14328

In the Matter of Marc A. Ellis, Respondent.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Marc A. Ellis ("Ellis" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that[1]:

Summary

These proceedings arise out of violations by GunnAllen Financial, Inc. ("GunnAllen"), formerly a Tampa, Florida-based broker-dealer, of Rule 30(a) of Regulation S-P (17 C.F.R. § 248.30(a)) (the "Safeguard Rule"). The Safeguard Rule requires broker-dealers to, among other things, adopt written policies and procedures reasonably designed to protect customer information against unauthorized access and use. Although GunnAllen maintained written supervisory procedures for safeguarding customer information, they were inadequate and failed to instruct the firm's supervisors and registered representatives how to comply with the Safeguard Rule. As Chief Compliance Officer ("CCO"), Ellis was charged with the responsibility of maintaining and reviewing the adequacy of GunnAllen's procedures for protecting customer information. However, after the theft of three laptop computers and a registered representative's computer password credentials put customer information collected by GunnAllen at risk of unauthorized access and use, Ellis did not direct the firm to revise or supplement its policies and procedures for safeguarding customer information. As a result, Ellis aided and abetted and caused GunnAllen's violations of the Safeguard Rule.

Respondent

1. Ellis, 44, resides in Dix Hills, New York. From July 2005 through February 2009, Ellis served as CCO of GunnAllen.

GunnAllen Financial, Inc.

2. GunnAllen had a principal place of business in Tampa, Florida and was registered with the Commission as a broker-dealer from March 1986 to April 2010. The firm operated mostly under an independent contractor model and maintained franchise offices nationwide. In April 2010, GunnAllen discontinued its operations, filed for bankruptcy, and submitted a Broker-Dealer Withdrawal, or "BDW", Form with the Commission withdrawing its registration. The withdrawal became effective on June 11, 2010.

GunnAllen's Safeguard Procedures

3. Rule 30(a) of Regulation S-P, or the Safeguard Rule, requires every broker and dealer registered with the Commission to adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information, and that are reasonably designed to: (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the

[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.

security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

4. Between July 2005 and February 2009, GunnAllen's policies and procedures addressing the protection of customer information were contained in its Written Supervisory Procedures Manual (the "Manual"). Specifically, the Manual included a provision, less than a page long, entitled "*Safeguarding Information.*" This provision was general and vague and, for several reasons, failed to set forth policies and procedures reasonably designed to protect customer information, as required by the Safeguard Rule. First, the provision simply recited the Safeguard Rule verbatim and provided examples of safeguards that "may be adopted" by GunnAllen, but did not specify any safeguards actually adopted by the firm, or otherwise require any of the listed safeguards be adopted. Second, the provision also failed to instruct GunnAllen's registered representatives how to protect customer information or enumerate the steps that they needed to take to ensure compliance with the Safeguard Rule. Moreover, the provision lacked procedures addressing the follow-up of breaches or potential breaches in customer information uncovered by GunnAllen and its registered representatives. Finally, the provision repeatedly referred to a "Designated Principal" charged with, among other things, monitoring and annually testing the firm's safeguards and identifying reasonably foreseeable risks warranting improvements or adjustments to the safeguards. However, the Manual failed to identify the "Designated Principal" by name or position and, in fact, GunnAllen did not appoint a "Designated Principal."

Breaches in GunnAllen's Customer Records

5. The inadequacy of GunnAllen's procedures for protecting customer information and the firm's failure to comply with the Safeguard Rule became apparent between August 2006 and February 2008. During that period, laptop computers belonging to three GunnAllen registered representatives and the computer password credentials belonging to a fourth were misappropriated from the firm. Although no reports of misuse of customer information as a result of any of the incidents subsequently arose, the thefts jeopardized the confidentiality and integrity of customer information maintained by the firm and placed some information at risk of unauthorized use that could have resulted in substantial harm or inconvenience to customers.

6. The first laptop computer was stolen in August 2006 from a GunnAllen franchise office in the Orlando, Florida area. The laptop contained contact records reflecting the names, addresses, and telephone numbers and, in many instances, spouses, dates of birth and social security numbers of approximately 1,120 of the firm's customers. GunnAllen filed a report of the theft with local police and considered, but did not send, a letter to the affected customers notifying them of the theft. The firm did not take any further steps concerning the matter and the laptop was never recovered.

7. In January 2007, a GunnAllen franchise office in the Scottsdale, Arizona area uncovered evidence that a registered representative who the firm had terminated almost a year earlier had misappropriated another employee's computer password credentials and was monitoring the employee's e-mails, including those exchanged with customers, from a remote location. GunnAllen's IT Department was notified about the compromised password and subsequently confirmed that the terminated representative had gained unauthorized access to the firm's e-mail system and had been accessing the employee's e-mail for at least three months and, possibly, as much as a year. GunnAllen directed its employees in the franchise office to change their computer password credentials and planned to implement an automated program, already under development, requiring employees on a firm-wide basis to periodically change their computer password credentials. The firm did not take any additional steps concerning the matter and did not contact criminal authorities although recommended by its IT Department.

8. Further, in February 2008, laptop computers were misappropriated from two GunnAllen registered representatives in separate incidences. The representatives reported the thefts to GunnAllen and informed the firm's IT Department that the laptops did not hold any customer information. GunnAllen did not take any further steps concerning the thefts and the laptop computers were never recovered.

9. GunnAllen's senior managers, including Ellis and the firm's General Counsel, learned of the aforementioned thefts, but no single person or department directed or coordinated the firm's responses to the thefts. As a consequence, GunnAllen failed to assess what, if any, risks the thefts posed to its customers and failed to take follow-up and remedial steps recommended by its employees. For example, after the theft of the first laptop computer, a dispute arose between GunnAllen's General Counsel and its IT Department, as to which department was responsible for sending a letter to the affected customers notifying them of the theft. A senior GunnAllen officer subsequently sent an e-mail to the General Counsel and Ellis, who was serving as the firm's CCO, stating that the letter should be sent to the affected customers, but it was never mailed.

Ellis Failed to Address GunnAllen's
<u>Inadequate Procedures for Safeguarding Customer information</u>

10. While serving as CCO of GunnAllen from July 2005 to February 2009, Ellis was responsible for implementing and maintaining policies and procedures ensuring the firm's compliance with Regulation S-P, including the Safeguard Rule mandating broker-dealers to adopt written policies and procedures reasonably designed to protect customer records and information. Ellis was also responsible for reviewing the adequacy of GunnAllen's written supervisory procedures contained in the Manual, including those concerning the Safeguard Rule. Ellis, with the assistance of the firm's Assistant Chief Compliance Officer, directed and oversaw GunnAllen's annual reviews of its written supervisory procedures in 2007 and 2008.

11. Ellis was notified of the laptop computer theft which occurred in August 2006 and the discovery of the misappropriated computer password credentials in January 2007 by e-mail after the events occurred. He was also orally informed of at least one of the two laptop computer thefts shortly after the event occurred in February 2008. These thefts and GunnAllen's limited response or follow-up repeatedly revealed the firm's policies and procedures for safeguarding customer information to be inadequate. Nevertheless, and despite supervising two annual reviews of GunnAllen's written supervisory procedures, Ellis failed to direct the firm to supplement the *Safeguarding Information* provision in the Manual or to adopt additional written policies and procedures to protect customer information and ensure GunnAllen's compliance with the Safeguard Rule.

12. As a result of the conduct described above, Ellis willfully[2] aided and abetted and caused GunnAllen's violations of Rule 30(a) of Regulation S-P under the Exchange Act, which requires written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer information that were reasonably designed to: (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records and information that could result in substantial harm or inconvenience to any customer.

IV.

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

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

A. Respondent Ellis cease and desist from committing or causing any violations and any future violations of Rule 30(a) of Regulation S-P under the Exchange Act.

B. Respondent Ellis is censured.

C. Respondent Ellis shall, within ten days of the entry of this Order, pay a civil money penalty of $15,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, or bank money order; (B) 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 Ellis as a Respondent in these proceedings, the file number of these

[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 *Huges v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949).

proceedings, a copy of which cover letter and wire transfer, money order or check shall be sent to Teresa J. Verges, Assistant Regional Director, Miami Regional Office, Securities and Exchange Commission, 801 Brickell Avenue, Suite 1800, Miami, FL 33131.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64241 / April 7, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3185 / April 7, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29626 / April 7, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14329

In the Matter of **DELTA GLOBAL ADVISORS, INC. AND CHARLES P. HANLON,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AND NOTICE OF HEARING**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Delta Global Advisors, Inc. ("Delta") and Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act against Charles P. Hanlon ("Hanlon", and together with Delta, "Respondents").

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II.

After an investigation, the Division of Enforcement alleges that:

SUMMARY

1. This proceeding involves numerous materially misleading statements and omissions by Delta, an investment adviser registered with the Commission, and Hanlon, Delta's principal and control person. During the relevant period, Delta misrepresented to existing and prospective investors its eligibility for Commission registration, including that it served as an investment adviser to a registered investment company and managed as much as $1.5 billion. In fact, Delta did not advise any such client and had at times no more than $9 million under management. These misrepresentations vastly exaggerated the significance and status of the firm. Moreover, Delta failed to disclose its poor financial condition, a default judgment entered against it in a breach of fiduciary duty lawsuit brought by a client, and that Hanlon had been the subject of disciplinary action by the Financial Industry Regulatory Authority ("FINRA"). As a result of these misleading statements and omissions, Delta appeared to be operationally sound and much larger and more established than it really was.

2. Although Hanlon represented to Commission examination staff that Delta would disclose its poor financial condition to clients, Delta never did so. In addition, even after Commission examination staff asked Delta to correct its Form ADV to accurately reflect its assets under management and deregister, Delta continued to misrepresent its assets under management and did not withdraw its registration.

RESPONDENTS

3. **Delta** is a California corporation based in Huntington Beach, California that registered with the Commission as an investment adviser on July 10, 2006. Hanlon wholly owns Delta. In 2009, Delta was providing discretionary advisory services to 209 accounts belonging to individuals, pension and profit-sharing plans, trusts, and corporations.

4. **Hanlon** is Delta's founder, president, and sole control person. At all relevant times, Hanlon was responsible for the management of Delta's business. From January 2005 through February 2007, Hanlon was associated with a registered broker-dealer, Delta Equity Services Corporation. FINRA suspended Hanlon from all registration capacities on June 29, 2010 for violating FINRA rules for failing to comply with an arbitration award.

RESPONDENTS MISREPRESENTED DELTA'S STATUS AS AN INVESTMENT ADVISER TO A REGISTERED INVESTMENT COMPANY AND ITS ASSETS UNDER MANAGEMENT

5. Between 2006 and 2008, Delta and Hanlon filed materially false Forms ADV that vastly exaggerated the significance and status of the firm. Specifically, Delta

falsely claimed that it was eligible for registration with the Commission, that it served as an investment adviser to a registered investment company, and that it managed assets far in excess of its actual assets under management.

6. From September 1, 2006 through March 27, 2008, Delta's Form ADV filings claimed that the firm was eligible for investment adviser registration with the Commission because it served as the investment adviser to a registered investment company. During the relevant time period, Delta had entered into several consulting agreements with the sponsor of unit investment trusts (the "trusts"), which were registered under the Investment Company Act.[1] Pursuant to the consulting agreements, Delta assisted the sponsor in selecting a portfolio of securities for the trusts and received a one-time fee for these services. While Delta served as an investment adviser to the trusts' sponsor for the limited period in which Delta advised on selection of securities for the trusts, Delta did not have an advisory contract with the registered investment company. Thus, contrary to what it represented in its Form ADV filings, Delta was not acting as an investment adviser to a registered investment company (the trusts) and Delta was not eligible for registration on that basis.

7. From March 7, 2007 through July 6, 2008, Delta's Form ADV filings improperly included the trusts' assets as Delta's advisory assets under management, even though Delta did not provide continuous and regular supervision of the trusts' assets. The inclusion of the trusts' assets vastly overstated the firm's reported size: in four separate filings Delta claimed to manage between $656 million and $1.49 billion in assets. In fact, during this period, Delta's assets under management dropped to as low as $9 million.

8. For nearly every period reflected in Delta's Form ADV filings, Delta did not have $25 million or more in advisory assets under management and therefore was not eligible for registration on that basis. In addition, as of June 30, 2009 (the date of its most recent Form ADV filing), Delta did not have $25 million or more in advisory assets under management.

9. Delta similarly misrepresented its assets under management through its website. Delta's website included a section containing articles from Bloomberg, Reuters, and other news sources quoting Delta's employees, including Hanlon. Many of these articles falsely stated that Delta had assets under management of $1 billion or more. For example, Delta's website included a January 23, 2009 Bloomberg article that stated: "'Everybody wants to buy gold, and these have been very healthily subscribed issues,'

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1 Section 4(2) of the Investment Company Act defines a UIT as "an investment company, which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities . . . ." Typically, these trusts do not have corporate officers, or an investment adviser. These trusts generally do not actively trade their investment portfolios – that is, a unit investment trust buys a relatively fixed portfolio of securities (for example, five, ten, or twenty specific stocks or bonds), and holds them with little or no change for the life of the trust.

Michael Pento, who helps oversee $1.5 billion at Delta Global Advisors . . . said in an interview." Similarly, a March 2, 2009 Bloomberg article on Delta's website stated: "'Silver's woken up recently, but it isn't flying yet,' said Chip Hanlon, president of Delta Global Advisors Inc. in Huntington Beach, California, which manages $1 billion."

10. At the time Delta filed its Forms ADV and posted articles to its website, Hanlon knew or was reckless in not knowing that the representations made about assets under management and providing advisory services to a registered investment company were materially false. In addition, even after Hanlon was advised by an investment advisory compliance firm and Commission staff that Delta was not acting as an investment adviser to a registered investment company and that it should not consider the trusts' assets as Delta's assets under management, Delta and Hanlon continued to post additional articles on Delta's website that included the trusts' assets as its assets under management.

11. In its July 7, 2008 Form ADV filing, Delta excluded the trusts' assets from its assets under management and no longer indicated that it provided investment advisory services to a registered investment company. In this filing, Delta indicated that it had $26 million in assets under management, but this was false. At that time Delta only had $16 million in assets under management.

12. Commission examination staff brought this matter to Hanlon's attention and, on March 31, 2009, Delta amended its Form ADV to reflect $16 million in assets under management, which was well below the $25 million threshold for registration. Only one day before Delta was required to file a Form ADV-W withdrawing its registration, Delta amended its Form ADV once again to reflect $26 million in assets under management. Hanlon admitted to Commission examination staff that Delta included $10 million in "hopeful" assets in this Form ADV filing as assets under management. Without these additional "hopeful" assets, Delta would not have been eligible for registration as an investment adviser. However, even after Commission examination staff requested that Delta correct its Form ADV and deregister, Delta continued to misrepresent its assets under management and did not withdraw its registration.

RESPONDENTS FAILED TO MAKE REQUIRED DISCLOSURES ABOUT DELTA'S POOR FINANCIAL CONDITION AND HANLON'S DISCIPLINARY HISTORY

13. In August 2009, Delta's financial condition was seriously impaired because it had minimal liquid assets and several overdue bills. On November 13, 2009, Delta informed Commission examination staff by letter that it was "in the process of communicating with all clients on this matter and will have completed this process by December 9, 2009." However, contrary to Delta's representations, Hanlon never disclosed Delta's financial condition to any clients.

14. On June 28, 2010, a default judgment was entered against Delta and Hanlon in a lawsuit filed by one of Delta's clients relating to Delta's advisory services. The lawsuit alleged breach of fiduciary duty, negligence, failure to supervise, negligent

misrepresentation, and breach of contract, all relating to Hanlon and Delta's activities as investment advisers. Among other things, the plaintiff claimed that Delta and Hanlon (i) did not follow plaintiff's investment guidelines and objectives, and (ii) failed to disclose certain conflicts of interest. The judgment ordered Delta and Hanlon to pay $353,706 in damages. Neither Delta nor Hanlon has satisfied the judgment. In addition, Delta did not disclose the existence of this judgment to Delta's clients or its precarious financial condition as a result of the unsatisfied judgment, even though it was required to do so.

15. In June 2010, a FINRA arbitration panel ordered Hanlon to pay compensatory damages of $272,290 and $5,500 in fees arising from a complaint against him alleging breach of contract, slander, and fraud. Hanlon failed to comply with this arbitration award and consequently on June 29, 2010 FINRA suspended Hanlon from acting in any registered capacity. Delta did not disclose this disciplinary action to its clients, even though it was required to do so.

VIOLATIONS

16. As a result of the conduct described above, Delta willfully violated, and Hanlon willfully aided, abetted, and caused Delta's violations of, Section 203A of the Advisers Act for having improperly registered with the Commission.

17. As a result of the conduct described above, Delta and Hanlon willfully violated Sections 206(1) and 206(2) of the Advisers Act by employing devices, schemes or artifices to defraud clients or engaging in transactions, practices or courses of business that defrauded clients or prospective clients.

18. As a result of the conduct described above, Delta and Hanlon willfully violated Section 207 of the Advisers Act by making untrue statements of a material fact in registration applications or reports Delta filed with the Commission and willfully omitting to state in such applications or reports material facts which were required to be stated therein.

19. As a result of the conduct described above, Delta willfully violated, and Hanlon willfully aided, abetted, and caused Delta's violations of, Section 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-4(a)(1) and (2) thereunder by engaging in the following acts, practices or courses of business which were fraudulent, deceptive or manipulative: (a) publishing, circulating or distributing advertisements that contained untrue statements of material facts, or that were otherwise false or misleading; (b) failing to disclose to clients or prospective clients all material facts regarding the financial condition of the adviser that are reasonably likely to impair the adviser's ability to meet its contractual commitments to clients; and (c) failing to disclose a legal or disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients.

III.

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

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

B. What, if any, remedial action is appropriate in the public interest against Respondent Hanlon pursuant to Section 15(b) of the Exchange Act;

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

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

E. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 9(b) of the Investment Company Act; and

F. Whether, pursuant to Section 203(k) of the Advisers Act, Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 203A, 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-4(a)(1) and (2) thereunder.

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64255 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14164

In the Matter of **C-3D Digital, Inc.,** **California Clean Air, Inc.,** **CEC Properties, Inc.,** **Censtor Corp.,** **The Centennial Group, Inc.,** **Century Technologies, Inc., and** **Chief Consolidated Mining Co.,** **Respondents.**	**ORDER MAKING FINDINGS AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO CHIEF CONSOLIDATED MINING CO.**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors to enter this Order submitted by Chief Consolidated Mining Co. ("Chief Consolidated Mining" or "Respondent") pursuant to Chief Consolidated Mining's Settlement Agreement with the Division of Enforcement of the Commission, Rule 240(a) of the Rules of Practice of the Commission, 17 C.F.R. § 201.240(a), for the purpose of settlement of these proceedings initiated against Respondent on December 17, 2010, and pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act").

II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Revoking Registration of Securities Pursuant to Section 12(j) of the

Securities Exchange Act of 1934 as to Chief Consolidated Mining Co. ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that[1]:

1. Chief Consolidated Mining (CIK No. 19913) is an Arizona corporation located in Eureka, Utah. At all times relevant to this proceeding, the securities of Chief Consolidated Mining have been registered with the Commission under Exchange Act Section 12(g). As of December 7, 2010, the company's common stock (symbol "CFCM") was quoted on the Pink Sheets.

2. Chief Consolidated Mining 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 since the period ended December 31, 2008.

IV.

In view of the foregoing, the Commission deems it necessary and appropriate for the protection of investors to impose the sanctions specified in Respondent's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Exchange Act Section 12(j), registration of each class of Respondent's securities registered pursuant to Exchange Act Section 12 be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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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.

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64257 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14330

In the Matter of

POWDER RIVER PETROLEUM INTERNATIONAL, INC.,

Respondent.

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES

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 Powder River Petroleum International, Inc. ("Powder River" 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, Respondent consents to the entry of this Order Instituting Proceedings Pursuant to Section 12(j) of the Securities Exchange Act of 1934, Making Findings, and Revoking Registration of Securities ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

A. Powder River, an Oklahoma corporation, is an oil-and-gas company. The common stock of Powder River has been registered under Section 12(g) of the Exchange Act since January 2001. Until September 19, 2008, Powder River stock was quoted on the NASDAQ OTCBB. It is currently quoted on the "Pink Sheets" disseminated by Pink OTC Markets, Inc.

B. Powder River has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission in that it has not filed an Annual Report on Form 10-K since April 14, 2008 or periodic or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending March 21, 2008.

C. Powder River has failed to comply with Section 10(b) of the Exchange Act and Rules 10b-5 and 12b-20 thereunder, by including materially false and misleading information in filings, including financial statements that failed to conform with Generally Accepted Accounting Principles, as required by Commission Regulation S-X, in its Annual Reports on Form 10-K for the calendar years ended December 31, 2004, 2005, 2006 and 2007, and in its Quarterly Reports on Form 10-Q for the quarters from March 31, 2005 through March 31, 2008.

D. Powder River has failed to comply with Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act by failing to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected the transactions and disposition of its assets, and by failing to maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles.

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 of 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.

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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.

In view of the foregoing, the Commission finds that it is 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 the registration of each class of Respondent'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

Chairman Schapiro
Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64271 / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3262 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14331

In the Matter of **Nicole Rae Kaplan, 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 Nicole Rae Kaplan ("Respondent" or "Kaplan") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

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

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

II.

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

III.

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

1. Kaplan, age 40, of Agoura Hills, California, became a certified public accountant licensed to practice in the State of California in 1996; her license expired in February 2005. Kaplan began work at Vitesse Semiconductor Corporation ("Vitesse" or the "Company"), in 1998 as Manager of Finance, and in 2004 she became the Company's Director of Finance. She officially resigned from Vitesse on April 14, 2006.

2. Vitesse based in Camarillo, California, is a major producer of high-performance integrated circuits for use primarily by systems manufacturers in the storage and communications industries. Vitesse was incorporated in Delaware in 1987, is headquartered in Camarillo, California, and maintains a September 30th fiscal year-end. During the relevant period, the Company's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the Nasdaq National Market under the symbol VTSS. The Company's common stock is currently traded on the Nasdaq National Market under the symbol "VTSS."

3. On March 22, 2011, a final judgment was entered against Kaplan, permanently enjoining her from future violations of Section 17(a) of the Securities Act of 1933; Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1, and 13b2-2 thereunder, and aiding and abetting 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, in the civil action entitled Securities and Exchange Commission v. Nicole R. Kaplan, et al., Civil Action Number 10-CV-9239, in the United States District Court for the Southern District of New York. Kaplan was also ordered to pay $31,050 in disgorgement of ill-gotten gains and $16,445 in prejudgment interest.

4. The Commission's complaint alleged, among other things, that Vitesse engaged in fraudulent revenue recognition practices that resulted in the Company filing with the Commission materially false and misleading financial statements in annual reports on Form 10-K and quarterly reports on Forms 10-Q from at least late 2001 through early 2006. The complaint alleges that Kaplan participated in prematurely and improperly recording revenues on product shipments to Vitesse's distributors and

customers; failed to timely and properly record customer credits from the return of unwanted product; and directed the misapplication of cash to account receivable balances in order to obscure the true age of the receivables. The complaint alleges that Kaplan engaged in the foregoing misconduct from late 2001 through 2005. As a result, the complaint alleges that Kaplan, among other violations: engaged in fraudulent accounting practices that materially misstated the company's annual and quarterly financial statements, which she reviewed or participated in preparing; knowingly circumvented or failed to implement Vitesse's system of internal accounting controls and falsified Vitesse's books, records, or accounts; and made material misrepresentations to Vitesse's independent auditor.

IV.

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

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

Kaplan 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
Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64272 / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3263 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14332

In the Matter of **Yatin Dilip Mody, 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 Yatin Dilip Mody ("Respondent" or "Mody") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

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

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

II.

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

III.

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

1. Mody, age 48, of Agoura Hills, California, has been a certified public accountant licensed to practice in the State of California since 1990; the status of his license is currently inactive. Mody began work at Vitesse Semiconductor Corporation ("Vitesse" or the "Company") in 1992 and served as Controller from 1993 through November 1998, at which time he was promoted to Vice President and Controller. Mody's job title changed slightly in 2002 to Vice President, Finance and Controller. In April 2005, he was promoted to Chief Financial Officer and thereafter served as Vice President, Finance and Chief Financial Officer. On May 17, 2006, Vitesse's Board of Directors terminated Mody due to concerns regarding the integrity of documents evidencing the Company's stock option grant practices.

2. Vitesse based in Camarillo, California, is a major producer of high-performance integrated circuits for use primarily by systems manufacturers in the storage and communications industries. Vitesse was incorporated in Delaware in 1987, is headquartered in Camarillo, California, and maintains a September 30th fiscal year-end. During the relevant period, the Company's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on the Nasdaq National Market under the symbol VTSS. The Company's common stock is currently traded on the Nasdaq National Market under the symbol "VTSS."

3. On March 22, 2011, a final judgment was entered against Mody, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933; Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13a-14, 13b2-1, and 13b2-2 thereunder, and aiding and abetting 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, in the civil action entitled Securities and Exchange Commission v. Yatin D. Mody, et al., Civil Action Number 10-CV-9239, in the United States District Court for the Southern District of New York. Mody was also ordered to pay $105,604 in disgorgement of ill-gotten gains and $56,716 in prejudgment interest, for a total of $162,320.

4. The Commission's complaint alleged, among other things, that Vitesse engaged in fraudulent revenue recognition practices that resulted in the Company filing with the Commission materially false and misleading financial statements in annual reports on Form 10-K and quarterly reports on Forms 10-Q from at least late 2001 through early 2006. The complaint alleges that Mody participated in prematurely and improperly recording revenues on product shipments to Vitesse's distributors and customers and failed to timely and properly record customer credits from the return of unwanted product. The complaint alleges that Mody engaged in the foregoing misconduct from late 2001 through 2005. As a result, the complaint alleges that Mody, among other violations: engaged in fraudulent accounting practices that materially misstated the company's annual and quarterly financial statements, which he reviewed and participated in preparing; knowingly circumvented or failed to implement Vitesse's system of internal accounting controls and falsified Vitesse's books, records, or accounts; and made material misrepresentations to Vitesse's independent auditor. The complaint further alleges that, as part of his misconduct, Mody signed and certified annual and quarterly reports containing false and misleading financial statements, including Vitesse's 2005 Form 10-K filed on December 13, 2005 and three Vitesse Forms 10-Q filed between May 2005 and February 2006, and that Mody signed in 2005 and 2006 certain Vitesse registration statements filed on Form S-8 and Form S-3 that incorporated by reference materially false and misleading Forms 10-K and/or Forms 10-Q.

IV.

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

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

Mody 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 EXCHANGE ACT OF 1934
Release No. 64277 / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3264 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14333

In the Matter of **TROY F. NILSON, CPA** **Respondent.**	**ORDER INSTITUTING PUBLIC 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 against Troy F. Nilson, CPA ("Respondent" or "Nilson") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

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1 Section 4C provides, in relevant part, that:

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) 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 engaged in unethical or improper professional conduct.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him, and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative 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:

A. SUMMARY

1. From year-end 2004 through the first quarter of 2008, Powder River Petroleum International, Inc. ("Powder River" or "the company") improperly accounted for over $43 million in proceeds from conveyances of fractional working interests in oil-and-gas leases to investors in Asia. In particular, Powder River immediately recognized revenue from the conveyances, despite the fact that it had promised the Asian working interest investors a guaranteed return until they recouped their initial investment. In addition, Powder River also improperly recorded assets it did not own or that were stated in excess of net realizable value. As a result, Powder River's financial statements did not present fairly, in all material respects, the company's financial position, operating results, and cash flows in conformity with generally accepted accounting principles. Powder River materially overstated its revenues by 7% to 2,417%, its pre-tax income by 18% to 441%, and its assets by 7% to 48% in its Commission filings during the applicable period.

2. Respondent was the engagement partner on the audit and review of Powder River's financial statements for year-end 2007 and the first quarter of 2008. Respondent failed to conduct these engagements in accordance with Public Company Accounting Oversight Board ("PCAOB") Standards. He also caused Chisholm, Bierwolf, Nilson and Morrill, LLC's failure to have procedures in place to detect fraud and to evaluate Powder River's ability to continue as a going concern. His failures as an auditor were a cause of Powder River's filing of a false and misleading 2007 Form 10-K and a first-quarter 2008 Form 10-Q. Accordingly, Respondent engaged in improper professional conduct, violated Sections 10A(a)(1) and 10A(a)(3) of the Exchange Act, and was a

[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.

cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder.

B. RESPONDENT

3. **Troy F. Nilson** is a certified public accountant licensed in the state of Utah and has been an audit partner at Chisholm, Bierwolf, Nilson and Morrill, LLC ("Chisholm Bierwolf") from 2004 to the present. Nilson was the engagement partner on Powder River's audit and quarterly review for year-end 2007 and the first quarter of 2008, and supervised Chisholm Bierwolf's engagements to audit and review Powder River's financial statements.

C. RELEVANT ENTITIES

4. **Powder River Petroleum International, Inc.** is an Oklahoma corporation headquartered in Calgary, Canada. The company's common stock is registered with the Commission pursuant to Exchange Act Section 12(g). Powder River's shares are currently quoted on Pink OTC Markets, Inc. In July 2008, an Oklahoma district court granted a temporary restraining order and appointed a receiver for Powder River in connection with a complaint filed by certain Asian investors.[4] In December 2008, Powder River filed for bankruptcy.[5] It has not restated its financial statements, other than a restatement of its 2007 quarterly financial statements included in its year-end 2007 financial statements, nor has it filed any reports with the Commission since September 17, 2008.

5. **Chisholm, Bierwolf, Nilson & Morrill, LLC,** a PCAOB-registered audit firm with offices in Bountiful and Layton, Utah, and its predecessors, have been Powder River's auditor since 2001.

D. FACTS

Oil-and-Gas Working Interest Conveyances

6. From year-end 2004 through the first quarter of 2008, Powder River offered and sold working interests in its oil-and-gas leases through an independent sales agent to investors in Singapore, Malaysia and Indonesia. Powder River's contracts with Asian investors provided that they would receive guaranteed payments yielding an annual minimum of 9%, and in some cases more, beginning approximately six months after the date of investment until investors reached the "break-even" point, i.e. when their principal had been repaid (the "guaranteed payments"). Thereafter, investors received lease production payments based on their respective working interests. By the second quarter of 2007, Powder River's guaranteed payments exceeded not only the investors' share of oil-and-gas production revenues, but also Powder River's total production

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4 *See Chang v. Powder River Petroleum Int'l, Inc.* (Okla. Dist. Ct. July 14, 2008) (No. CJ-2008-4855).

5 *See In re Powder River Petroleum Int'l, Inc.* (Bankr. W.D. Okla. Dec. 12, 2008) (No. 08-15613).

revenues. After that date, Powder River used proceeds from working interest conveyances to new investors to fund guaranteed payments to earlier investors.

7. From year-end 2004 through the first quarter of 2008, Powder River improperly recognized as revenue over $33.5 million in proceeds from conveyances of the working interests to investors. These conveyances were in substance and should have been reported by Powder River as borrowings, not revenue (*see* Financial Accounting Standards No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, paragraph 43). The investors' contractual right to receive guaranteed payments until their "break-even point" represented, in substance, a loan of capital to Powder River at a guaranteed 9% minimum rate of return. As a result of Powder River's improper accounting, the company materially overstated its revenues in its Forms 10-QSB, 10-Q, 10-KSB, and 10-K for the year ended December 31, 2004 through the quarter ended March 31, 2008 by 7% to 2,417% and its net pre-tax income by 18% to 441%.

8. Respondent supervised Powder River's 2007 audit and first-quarter 2008 review. In the second quarter of 2007, when the guaranteed payments exceeded Powder River's entire oil-and-gas receipts, the company began recording the guaranteed payments on its balance sheet as an asset labeled "pre-paid production payments." During the 2007 audit, Respondent examined some of the contracts underlying the working interest conveyances, which described the guaranteed payments, and determined that Powder River's accounting for those payments as an asset was improper. Respondent failed, however, to consider whether, as a result of the guaranteed payment provisions, the conveyances should have been reported as borrowings rather than sales.

9. The company filed a Form 8-K on March 17, 2008, which disclosed the guaranteed payments and indicated that the company's second and third quarter 2007 financial statements could not be relied upon. When Powder River filed its 2007 Form 10-K and first-quarter 2008 Form 10-Q, the company disclosed the guaranteed payments as a future commitment in its financial statement footnotes. As a result of Respondent's failure to consider the nature of the guaranteed payments on Powder River's revenue recognition, however, the company continued to improperly report the proceeds from its working interest conveyances as revenues.

10. Furthermore, Respondent was aware that Powder River's guaranteed payments exceeded the company's total oil-and-gas revenues for 2007. Yet, he failed to include a "going concern" paragraph in Chisholm Bierwolf audit opinion, despite substantial reason to doubt that Powder River's future oil-and-gas revenues, which were only $3.3 million in 2007, would be sufficient to cover the $6.1 million of guaranteed payments due in 2008.

Inflated Assets

11. Powder River reported assets that it did not own, that did not exist, or that it should have written off in its 2007 Form 10-K and first-quarter 2008 Form 10-Q financial statements. During the company's 2007 audit, Respondent failed to conduct sufficient audit procedures to support the recorded oil-and-gas and other assets; otherwise he would have discovered information that indicated a significant amount of such assets should be removed from Powder River's

financial statements. As a result, the company overstated its assets by 45% and 48% in its financial statements for year-end 2007 and first-quarter 2008, respectively.

12. In particular, Powder River improperly included as assets in its year-end 2007 and first-quarter 2008 financial statements two oil-and-gas leases it had agreed, but failed, to acquire. Specifically, in 2005, Powder River made $500,000 in nonrefundable payments as a part of an agreement to acquire a New Mexico oil-and-gas lease for $5 million, but by August 2005 it had defaulted on the terms of the agreement and lost its rights to the lease. Nonetheless, Powder River continued to report the lease as an asset on its balance sheet, including in its financial statements for year-end 2007 and the first quarter of 2008, which was its last quarterly report. Similarly, Powder River made nonrefundable payments totaling $1.5 million in late 2006 and early 2007 as part of an agreement to acquire a Texas oil-and-gas lease for $6.5 million. The company reported the lease, along with an associated note payable, as assets on its balance sheet from year-end 2006 onward. In reality, the agreement was never consummated, no note agreement was ever executed, and by the end of 2007, Powder River had forfeited its payments.

13. During Powder River's 2007 audit, Respondent failed to perform procedures to verify the existence and ownership of the New Mexico and Texas leases, despite the size of the assets and the fact that the company had not paid any significant development costs or taxes on the properties in 2007. Respondent did not review the oil-and-gas lease purchase documents or any promissory note agreement on the Texas lease. During the 2007 audit, Respondent requested confirmation of the purported $5 million promissory note on the Texas lease, but failed to perform sufficient alternative procedures when the confirmation was not returned.

14. Powder River listed a $1.2 million item as a "loan receivable" on the company's balance sheet in its 2007 Form 10-K financial statements. In prior periods, this item was reported as a cash or cash equivalent. Despite this unexplained change in accounting treatment and the fact that no payments had ever been made on the loan receivable, Respondent failed to obtain documentation of the purported loan receivable or to perform any procedures to evaluate the collectability of the loan. Further, Respondent failed to identify that the loan receivable had not been disclosed as a related party transaction in compliance with Statement of Financial Accounting Standard No. 57, *Related Party Disclosures*.

<u>Failure to Assess the Work of a Professional</u>

15. At year-end 2007, oil-and-gas properties represented approximately 82% of Powder River's total assets. The company, however, failed to obtain new or updated reserve reports in 2007, instead relying on the reports that it had used in connection with the 2006 audit. In auditing Powder River's 2007 financial statements, Respondent relied on the work performed in the audit of Powder River's 2006 financial statements, without performing procedures to test or verify the scope or adequacy of that prior audit work or the 2006 reserve reports. Respondent did nothing to: a) evaluate the qualifications of the petroleum engineer who prepared the oil-and-gas reserve reports; b) understand the nature of the work performed in preparing the oil-and-gas reserve reports; and c) evaluate the petroleum engineer's relationship to Powder River. Respondent knew or should have known that Powder River's failure to obtain new or updated reserve reports raised questions as to:

a) the qualifications of the engineer who prepared the reserve reports; and b) the adequacy of the reserve reports to support disclosures made in the financial statements. Accordingly, Respondent failed to adhere to the guidance contained in AU 336, *Using the Work of a Specialist*, and failed to obtain sufficient competent evidential matter to support Chisholm Bierwolf's report on Powder River's 2007 financial statements.

Creation of Audit Documents

16. Prior to a PCAOB inspection in 2007, Respondent created and back-dated and directed Chisholm Bierwolf's staff to create and back-date audit planning and other documents more than 45 days after the documentation completion dates for the 2006 audit of Powder River's financial statements. Respondent and his firm's staff failed to document in the workpapers the dates that these changes were made, the names of the persons who made them, and the reasons for adding information. They also failed to notify the PCAOB inspection team that changes had been made to the audit files without appropriately documenting the date of those changes. As a result, Respondent failed to comply with PCAOB Auditing Standard No. 3, *Audit Documentation*, in addition to violating PCAOB rules. Respondent produced those documents to SEC staff during its investigation, without disclosing that they had been back-dated or created after document completion deadlines.

Failure to Conduct Audits in Accordance with PCAOB Standards

17. As the foregoing conduct demonstrates, Respondent failed to conduct Powder River's 2007 audit in accordance with PCAOB Standards and Rules. Specifically, Respondent failed to:

a. Adequately plan the audit and properly supervise assistants, under AU 311, ¶8, *Planning & Supervision.*

b. Gather sufficient competent evidential matter, under AU 326, ¶13, *Audit Evidence*, to support the characterization of Powder River's revenue and his conclusions on company assets;

c. Exercise due professional care and skepticism, under AU 230, ¶¶9, 25, *Due Professional Care in the Performance of Work*, as illustrated by repeated failures to review underlying documentation, undue reliance on management, and failure to respond appropriately to "red flags."

d. Perform sufficient alternative procedures, under AU 330, ¶31, *The Confirmation Process*, when his firm did not receive proper confirmations of a promissory note and a loan receivable;

e. Evaluate, under AU 341, ¶3, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, Powder River's ability to continue as a going concern even though the fact that Powder River's total revenues were significantly less than its guaranteed payment obligations should have raised substantial doubt about its ability to continue as a going concern;

f. Consider whether, under AU 336, ¶¶8, 9, *Using the Work of a Specialist*, Powder River's petroleum engineers possessed the necessary qualifications for their work to be used as audit evidence; and

g. Properly prepare audit documentation, under PCAOB Auditing Standard No. 3, ¶15, *Audit Documentation*, as demonstrated by after-the-fact creation and back-dating of audit planning documents and checklists at Respondent's direction.

18. Furthermore, Respondent did not have procedures in place for the 2007 audit designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on Powder River's financial statement amounts, as required by Section 10A(a)(1) of the Exchange Act. This was demonstrated by Respondent's failure to recognize Powder River's improper revenue recognition, his failure to identify assets improperly included on its balance sheet, and his reliance on out-dated reserve reports that failed to support Powder River's reported reserves.

19. Respondent also did not include in the 2007 audit an evaluation of whether there was substantial doubt about the ability of Powder River to continue as a going concern during the ensuing fiscal year, as required by Section 10A(a)(3) of the Exchange Act. This is demonstrated by his failure to recognize that Powder River's total revenues in 2007 were significantly less than its guaranteed payment obligations for the following year, which should have raised substantial doubt about the company's ability to continue as a going concern.

E. VIOLATIONS

20. Exchange Act Section 10A(a)(1) requires each audit to include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts, and Section 10A(a)(3) requires each audit to include an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year. No showing of *scienter* is necessary to establish a violation of Section 10A. *See SEC v. Solucorp Indus., Ltd.*, 197 F. Supp. 2d 4 (S.D.N.Y. 2002).

21. As discussed above, Respondent violated Sections 10A(a)(1) and 10A(a)(3) by failing to have adequate procedures in place during Powder River's 2007 audit to: 1) reasonably assure detection of illegal acts, such as Powder River's material overstatement of its revenues, its inclusion of improperly recorded assets on its balance sheet, and its materially overstated oil-and-gas reserves, and its payments of later working interest conveyance proceeds to earlier working interest investors, which materially affected the determination of financial statement amounts; and

2) to evaluate whether there was substantial doubt about Powder River's ability to continue as a going concern.

22. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder, require every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission information, documents, and annual and quarterly reports as the Commission may require, and mandate that periodic reports contain such further material information as may be necessary to make the required statements not misleading. The obligation to file such reports 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), *cert. denied*, 440 U.S. 913 (1979).

23. As discussed above, during year-end 2007 and the first quarter of 2008, Respondent's failures were a cause of Powder River's filing of a false and misleading 2007 Form 10-K and first-quarter 2008 Form 10-Q. Accordingly, Respondent was a cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder.

24. Rule 102(e)(1)(ii) of the Commission's Rules of Practice and Section 4C of the Exchange Act authorize the Commission to censure or deny, temporarily or permanently, the privilege of appearing or practicing before the Commission to accountants who are found to have engaged in improper professional conduct. Under Rule 102(e)(1)(iv), the term "improper professional conduct" means, in part, "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." Respondent's actions were unreasonable and failed to conform to applicable professional standards. Accordingly, his conduct supports an action under Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Rules of Practice.

F. FINDINGS

25. Based on the foregoing, the Commission finds that Respondent violated Sections 10A(a)(1) and 10A(a)(3) of the Exchange Act, and was a cause of Powder River's violations of Section 13(a) of the Exchange Act, and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder.

26. Based on the foregoing, the Commission finds that Respondent engaged in improper professional conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice.

G. UNDERTAKING

27. Cooperation. Respondent undertakes to cooperate fully with the Commission with respect to any matter relating to the Commission's investigation of Powder River or its current or former officers, directors, employees, or auditors, including but not limited to any litigation or other proceeding related to or resulting from that investigation. Such cooperation shall include, but is not limited to, upon reasonable notice and without subpoena:

a. Producing any document, record, or other tangible evidence reasonably requested by Commission staff in connection with the Commission's investigation, litigation or other proceedings;

b. Providing all information reasonably requested by Commission staff in connection with the Commission's investigation; and

c. Attending and providing truthful statements at any meeting, interview, testimony, deposition, trial, or other legal proceeding reasonably requested by the Commission staff.

28. In determining whether to accept the Offer, the Commission has considered these undertakings.

IV.

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

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

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 10A(a)(1) and 10A(a)(3) of the Exchange Act.

B. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder.

C. Respondent is denied the privilege of appearing or practicing before the Commission as an accountant.

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

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

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

a. Respondent, or the public accounting firm with which he is associated, is registered with the PCAOB 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 PCAOB and that inspection did not identify any criticisms of or potential defects in 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 PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (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 PCAOB, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

E. 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
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 EXCHANGE ACT OF 1934
Release No. 64278 / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3265 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14334

In the Matter of **JEFFERY Q. JOHNSON, CPA** **and** **STEVEN M. HANNI, CPA,** **Respondents.**	**ORDER INSTITUTING PUBLIC 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 against Jeffery Q. Johnson, CPA ("Johnson") and Steven M. Hanni, CPA ("Hanni") (collectively "Respondents") 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]

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1 Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(iii) provides, in pertinent part, that:

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 Public 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 Respondents' Offer, the Commission finds[3] that:

A. SUMMARY

1. From year-end 2004 through the first quarter of 2008, Powder River Petroleum International, Inc. ("Powder River") improperly accounted for over $43 million in proceeds from conveyances of fractional working interests in oil-and-gas leases to investors in Asia. In particular, Powder River immediately recognized revenue from the conveyances, despite the fact that it had promised the Asian working interest investors a guaranteed return until they recouped their initial investment. In addition, Powder River also improperly recorded assets it did not own or that were stated in excess of net realizable value. As a result, Powder River's financial statements did not present fairly, in all material respects, the company's financial position, operating results, and cash flows in conformity with generally accepted accounting principles. Powder River materially overstated its revenues by 7% to 2,417%, its pre-tax income by 18% to 441%, and its assets by 7% to 48% in its Commission filings during the applicable period.

2. Respondents incorrectly advised Powder River on how it should record financial items, including revenue from the working-interest conveyances from 2005 through August 2007. After August 2007, Johnson, as CFO, and Hanni, assisting Johnson as a *de facto* co-CFO, supervised and directed the company's improper recording of its assets and its revenue from the working-interest conveyances. By mid-2007, Powder River used proceeds from current

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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.

[3] 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.

working interest conveyances to pay the guaranteed returns to earlier Asian investors. In mid-March 2008, Johnson authorized one of those payments, but failed to disclose in Powder River's first quarter 2008 Form 10-Q that the company was using later investor funds to pay earlier investors.

B. RESPONDENTS

3. **Jeffery Q. Johnson** is a certified public accountant licensed in the state of Utah and was employed at Stayner Bates & Jensen, PC ("Stayner Bates") from January 2006 until November 2010. Johnson provided bookkeeping, financial reporting, and other accounting services to Powder River from June 2006 until August 2007, when he contracted with Powder River to serve as Powder River's CFO on a part-time basis. Johnson resigned as Powder River's CFO in September 2008. While CFO, Johnson remained employed at Stayner Bates.

4. **Steven M. Hanni** is a certified public accountant licensed in the state of Utah and served as the engagement partner on Stayner Bates's engagement to provide bookkeeping, financial reporting, and other accounting services to Powder River from 2004 to August 2007. Pursuant to Johnson and Powder River's arrangement with NJS Management, LLC, Hanni assisted Johnson with his duties as Powder River's CFO.

C. RELEVANT ENTITIES

5. **Powder River Petroleum International, Inc.** is an Oklahoma corporation headquartered in Calgary, Canada. The company's common stock is registered with the Commission pursuant to Exchange Act Section 12(g). Powder River's shares are currently quoted on Pink OTC Markets, Inc. In July 2008, an Oklahoma district court granted a temporary restraining order and appointed a receiver for Powder River in connection with a complaint filed by certain Asian investors.[4] In December 2008, Powder River filed for bankruptcy.[5] It has not restated its financial statements, other than a restatement of its 2007 quarterly financial statements included in its year-end 2007 financial statements, nor has it filed any reports with the Commission since September 17, 2008

6. **Stayner Bates & Jensen, PC**, a CPA firm located in Salt Lake City, Utah, became registered with the Public Company Accounting Oversight Board ("PCAOB") in 2009, and has no public company audit clients. From 2004 through August 2007, Powder River engaged Stayner Bates to provide bookkeeping, financial reporting, and other accounting services.

7. **NJS Management, LLC** ("NJS"), a Utah limited liability company, was formed by Johnson, Hanni, and another Stayner Bates partner to provide CFO services. Powder River had an agreement with Johnson through which Powder River paid NJS the money representing Johnson's salary from Powder River. That money was then split amongst Johnson,

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4 *See Chang v. Powder River Petroleum Int'l, Inc.* (Okla. Dist. Ct. July 14, 2008) (No. CJ-2008-4855).

5 *See In re Powder River Petroleum Int'l, Inc.* (Bankr. W.D. Okla. Dec. 12, 2008) (No. 08-15613).

for services rendered as Powder River's CFO; Hanni, for assisting Johnson with his duties as Powder River's CFO; and another Stayner Bates partner, for increased assistance to Johnson in connection with other Stayner Bates engagements.

D. FACTS

Oil-and-Gas Working Interest Conveyances

8. From year-end 2004 through the first quarter of 2008, Powder River offered and sold working interests in its oil-and-gas leases through an independent sales agent to investors in Singapore, Malaysia and Indonesia. Powder River's contracts with Asian investors provided that they would receive guaranteed payments yielding an annual minimum of 9%, and in some cases more, beginning approximately six months after the date of investment until investors reached the "break-even" point, i.e. when their principal had been repaid (the "guaranteed payments"). Thereafter, investors received lease production payments based on their respective working interests. By the second quarter of 2007, Powder River's guaranteed payments exceeded not only the investors' share of oil-and-gas production revenues, but also Powder River's total production revenues. After that date, Powder River used proceeds from working interest conveyances to new investors to fund guaranteed payments to earlier investors.

9. From year-end 2004 through the first quarter of 2008, Powder River improperly recognized as revenue over $33.5 million in proceeds from conveyances of the working interests to investors. These conveyances were in substance and should have been reported by Powder River as borrowings, not revenue (*see* Financial Accounting Standards No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, paragraph 43). The investors' contractual right to receive guaranteed payments until their "break-even point" represented, in substance, a loan of capital to Powder River at a guaranteed 9% minimum rate of return. As a result of Powder River's improper accounting, the company materially overstated its revenues in its Forms 10-QSB, 10-Q, 10-KSB and 10-K for the year ended December 31, 2004 through the quarter ended March 31, 2008 by 7% to 2,417% and its net pre-tax income by 18% to 441%.

10. Beginning in 2005, Powder River hired Stayner Bates to provide bookkeeping, reporting and other accounting services. Hanni was the partner and oversaw the firm's engagement from 2005 through August 2007. Johnson joined Stayner Bates in January 2006 and began assisting Hanni on the Powder River engagement in June 2006. In connection with this engagement, Hanni and Johnson provided accounting and reporting advice with respect to acquisitions and conveyances of oil-and-gas interests and drafted Powder River's financial statements for inclusion in Powder River's SEC filings. Respondents advised the company regarding the appropriate accounting for the working-interest-conveyance proceeds without reviewing underlying documents, which reflected the guaranteed payments to investors. Instead, Respondents relied, without further inquiry, on Powder River management's representations and characterization of the working interest conveyances as "sales." As a result, Powder River: a) failed to disclose and account properly for the guaranteed payments; and b) improperly reported the working interest conveyance proceeds as revenue in financial statements included in its Forms 10-K and Forms 10-Q for year-end 2005 through the second quarter of 2007.

11. During the preparation of Powder River's financial statements for the year ended December 31, 2006, Respondents became aware of Powder River's 9% payments to the working interest investors. Yet, Hanni failed to analyze the significance of those payments and erroneously advised Powder River to net them against oil-and-gas production revenues. As a result, Powder River continued to record the working interest conveyance proceeds as revenue, failed to disclose the guaranteed payments, and improperly offset the guaranteed payments against the company's oil-and-gas production receipts in its 2006 Form 10-KSB and first quarter 2007 Form 10-QSB.

12. In the second quarter of 2007, when the guaranteed payments exceeded the company's total oil-and-gas receipts, Respondents erroneously advised the company to record the guaranteed payments on the company's balance sheet as an asset labeled as "pre-paid production payments." As a result, Powder River continued to record the working interest conveyance proceeds as revenue, failed to disclose the guaranteed payments, and mischaracterized those payments as an asset in its financial statements included in its second quarter 2007 Form 10- QSB.

13. In August 2007, Powder River named Johnson as Powder River's CFO and began paying NJS for his and Hanni's CFO services. It was understood between Powder River and NJS that Respondents would function together as Powder River's CFO, yet they failed to assess Powder River's revenue recognition policy for working interest conveyances and the appropriate accounting and reporting of the conveyances and related guaranteed payments to investors. As a result, Powder River continued to record the working interest conveyance proceeds as revenue in its financial statements filed in its third-quarter 2007 Form 10-QSB and first-quarter 2008 Form 10-Q, and in its 2007 Form 10-K.

14. While preparing for the audit of Powder River's 2007 financial statements, Respondents concluded that Powder River had improperly reported the guaranteed payments as an asset on Powder River's balance sheet in its second and third-quarter 2007 financial statements. As a result, on March 17, 2008, Powder River filed a Form 8-K in which it first publicly disclosed the guaranteed payments and indicated that the company's second and third quarter 2007 financial statements could not be relied upon. Respondents did not, however, change the company's recognition of revenue from the working interest conveyances in its year-end 2007 financial statements. Instead, in its 2007 Form 10-K, the company simply disclosed the guaranteed payments and identified them as a future commitment in a footnote to the year-end 2007 financial statements. As a result, Powder River continued to materially overstate its revenues and pre-tax income in financial statements included in its 2007 Form 10-K and its first quarter 2008 Form 10-Q. Johnson, as Powder River's principal accounting officer, certified Powder River's 2007 Form 10-K financial statements.

15. In early March 2008, Johnson authorized Powder River's independent sales agent to use new working interest investor funds the agent had collected to make guaranteed payments to previous investors. Johnson subsequently supervised the preparation of financial statements for Powder River's first quarter 2008 Form 10-Q, which he certified as company principal accounting officer. In this filing and Powder River's March 17, 2008 Form 8-K, the company failed to disclose that the company was using proceeds from current working interest conveyances to fund guaranteed payments to earlier investors. Johnson failed to disclose to Powder River's auditor that he had authorized guaranteed payments to existing investors from new investors' funds.

Inflated Assets

16. Powder River reported assets that it did not own, that did not exist, or that it should have written in financial statements included in its 2005, 2006 and 2007 Forms 10-KSB and 10-K and for its Forms 10-QSB and 10-Q for the first, second and third quarters of 2005, 2006, and 2007 and the first quarter of 2008, thereby inflating its assets between 37% and 48%. After Johnson became CFO, he and Hanni failed to devise and maintain a system of accounting controls to validate the existence of the assets reported on the company's balance sheet, evaluate reported assets for potential impairment, or to ensure that Powder River's financial statements were prepared in accordance with generally accepted accounting principles. Accordingly, Hanni and Johnson were a cause of the misstatements in Powder River's financial statements.

17. In particular, Powder River improperly included as assets on its financial statements two oil-and-gas leases it had agreed, but failed, to acquire. Specifically, in 2005, Powder River made $500,000 in nonrefundable payments as a part of an agreement to acquire a New Mexico oil-and-gas lease for $5 million, but by August 2005 it had defaulted on the terms of the agreement and lost its rights to the lease. Nonetheless, Powder River continued to report the lease as an asset on its balance sheet from the third quarter of 2005 through the first quarter of 2008, which was its last quarterly report. Similarly, Powder River made nonrefundable payments totaling $1.5 million in late 2006 and early 2007 as part of an agreement to acquire a Texas oil-and-gas lease for $6.5 million. The company reported the lease, along with an associated note payable, as assets on its balance sheet from year-end 2006 onward. In reality, the agreement was never consummated, no note agreement was ever executed, and by the end of 2007 Powder River had forfeited its payments. Without verifying the CEO's characterization of these transactions, Johnson and Hanni allowed Powder River to report the leases as assets on its balance sheet.

18. In addition, Powder River listed a $1.2 million item as a "loan receivable" on the company's balance sheet in its 2007 Form 10-K financial statements. In prior periods, this item was reported as a cash or cash equivalent. In its financial statements included in its 2007 Form 10-K, Powder River reclassified a $1.2 item from "cash," where it had been improperly classified since year-end 2006, to "loan receivable" on its balance sheet. This item represented a loan receivable from a related party, yet had not been previously disclosed as required by Statement of Financial Accounting Standard No. 57, *Related Party Disclosures*. Although the loan was uncollectible and the company never received any loan payments, Respondents failed to evaluate the collectability of the loan receivable at year end 2007, thereby causing the company to overstate its assets in financial statements included in its 2007 Form10-K.

E. VIOLATIONS

19. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit a person, in connection with the purchase or sale of a security, from making an untrue statement of a material fact or from omitting to state a material fact necessary to make statements made, in light of the circumstances under which they were made, not misleading. To violate Section 10(b) or Rule 10b-5, a defendant must act with *scienter*, *Aaron v. SEC*, 446 U.S. 680, 695, 701-02 (1980), which the Supreme Court has defined as "a mental state embracing intent to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). *Scienter* may be established by showing that the respondents acted intentionally or with severe recklessness. *See, e.g.*, *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981). During March 2008, Johnson authorized guaranteed payments to existing investors from new investor funds. He failed, however, to disclose those payments in the first quarter 2008 Form 10-Q, which he signed and certified. As a result of his severely reckless conduct, Johnson willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[6]

20. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13, and 12b-20 thereunder, require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information, documents, and annual and quarterly reports as the Commission may require, and mandate that periodic reports contain such further material information as may be necessary to make the required statements not misleading. The obligation to file such reports 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), *cert. denied*, 440 U.S. 913 (1979). As discussed above, Johnson caused Powder River's false and misleading quarterly and annual Commission reports for third-quarter 2007, year-end 2007, and first-quarter 2008. Hanni caused Powder River's false and misleading quarterly and annual Commission reports from year-end 2005 through the first quarter of 2008. Johnson caused Powder River's false and misleading Form 8-K dated March 17, 2008. Accordingly, Johnson and Hanni willfully aided and abetted and caused Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder, and Johnson willfully aided and abetted and caused Powder River's violations of Rule 13a-11.

21. Rule 13a-14 promulgated under the Exchange Act requires an issuer's principal executive and financial officer to certify in each quarterly and annual report filed or submitted by the issuer under Exchange Act Section 13(a), that: (1) they have reviewed the report; and (2) based on their knowledge, the report does not contain any untrue statement of material fact, or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report. As discussed above, Johnson certified Powder River's periodic reports from

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6 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)). "Willfulness" does not require 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)).

the third quarter of 2007 through the first quarter of 2008, which misstated Powder River's revenue, net income and assets, and omitted to state that Powder River was using new investor proceeds to pay previous investors. Accordingly, Johnson willfully violated Exchange Act Rule 13a-14.

22. 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. As described above, Respondents' conduct from the third quarter of 2007 through the first quarter of 2008 was a cause of Powder River's improper recording of transactions in its books and records. Accordingly, Johnson and Hanni willfully aided and abetted and caused Powder River's violations of Section 13(b)(2)(A) of the Exchange Act.

23. Section 13(b)(2)(B) requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles. As discussed above, after August 2007, Respondents were responsible for Powder River's failure to devise and maintain a system of internal accounting controls to properly record the company's financial information, including its assets. As a result, Respondents willfully aided and abetted and caused Powder River's violations of Section 13(b)(2)(B) of the Exchange Act.

24. 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. Rule 13b2-1 also prohibits the falsification of any book, record, or account subject to Section 13(b)(2)(A). Rule 13b2-2(a) prohibits an officer or director of an issuer from, directly or indirectly: (1) making, or causing to be made, a materially false or misleading statement; or (2) omitting, or causing to be omitted, a statement of a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to an accountant in connection with a required audit, or the preparation or filing of a required document or report. As discussed above, Johnson authorized payments to existing investors from new investor funds that he failed to properly record or disclose to auditors or in Powder River's first quarter of 2008 Form 10-Q. Therefore, Johnson willfully violated Section 13(b)(5) of the Exchange Act and Rules 13b2-1 and 13b2-2 thereunder.

F. FINDINGS

25. Based on the foregoing, the Commission finds that:

a. Johnson willfully violated Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13a-14, 13b2-1 and 13b2-2 promulgated thereunder, and willfully aided and abetted and caused Powder River's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 13a-1, 13a-11, 13a-13, and 12b-20 promulgated thereunder;

b. Hanni willfully aided and abetted and caused Powder River's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder; and

c. Johnson willfully violated Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13a-14, 13b2-1 and 13b2-2 promulgated thereunder, and he and Hanni willfully aided and abetted Powder River's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 13a-1, 13a-11, 13a-13, and 12b-20 promulgated thereunder, within the meaning of Exchange Act Section 4C and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

G. UNDERTAKINGS

26. **Cooperation**. Respondents undertake to cooperate fully with the Commission with respect to any matter relating to the Commission's investigation of Powder River or its current or former officers, directors, employees, or auditors, including but not limited to any litigation or other proceeding related to or resulting from that investigation. Such cooperation shall include, but is not limited to, upon reasonable notice, and without subpoena:

a. Producing any document, record, or other tangible evidence reasonably requested by Commission staff in connection with the Commission's investigation, litigation or other proceedings;

b. Providing all information reasonably requested by Commission staff in connection with the Commission's investigation; and

c. Attending and providing truthful statements at any meeting, interview, testimony, deposition, trial, or other legal proceeding reasonably requested by the Commission staff.

27. In determining whether to accept the Offer, the Commission has considered these undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offer.

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

A. JOHNSON

Johnson shall cease and desist from committing or causing any violations and any future violations of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13a-1, 13a-11, 13a-13, 12b-20, 13a-14, 13b2-1 and 13b2-2 promulgated thereunder.

Pursuant to Section 21C(f) of the Exchange Act, Johnson is prohibited, for a period of five years from the date of this Order, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

Johnson is denied the privilege of appearing or practicing before the Commission as an accountant.

After five years from the date of this Order, Johnson 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 Johnson'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. Johnson, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

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

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

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

The Commission will consider an application by Johnson 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 Johnson's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

B. HANNI

Hanni shall cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder.

Hanni is denied the privilege of appearing or practicing before the Commission as an accountant.

After two years from the date of this Order, Hanni 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 Hanni'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. Hanni, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

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

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

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

The Commission will consider an application by Hanni 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 Hanni's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

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 EXCHANGE ACT OF 1934
Release No. 64279 / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3266 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14335

In the Matter of **TODD D. CHISHOLM, CPA,** **Respondent.**	**ORDER INSTITUTING PUBLIC 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 against Todd D. Chisholm, CPA ("Respondent") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

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1 Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) 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 engaged in unethical or improper professional conduct.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative 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:

A. SUMMARY

1. From year-end 2004 through the first quarter of 2008, Powder River Petroleum International, Inc. ("Powder River" or "the company") improperly accounted for over $43 million in proceeds from conveyances of fractional working interests in oil-and-gas leases to investors in Asia. In particular, Powder River immediately recognized revenue from the conveyances, despite the fact that it had promised the Asian working interest investors a guaranteed return until they recouped their initial investment. In addition, Powder River also improperly recorded assets it did not own or that were stated in excess of net realizable value. As a result, Powder River's financial statements did not present fairly, in all material respects, the company's financial position, operating results, and cash flows in conformity with generally accepted accounting principles. Powder River materially overstated its revenues by 7% to 2,417%, its pre-tax income by 18% to 441%, and its assets by 7% to 48% in its Commission filings during the applicable period.

2. From year-end 2004 through the third quarter of 2007, Respondent was the engagement partner on Powder River's audits and reviews. He failed to conduct these engagements in accordance with Public Company Accounting Oversight Board ("PCAOB") Standards. Respondent also caused Chisholm, Bierwolf, Nilson and Morrill, LLC's failure to have procedures in place to detect fraud and his failures as an auditor were a cause of Powder River's filing of false and misleading Forms 10-QSB and 10-KSB. Accordingly, Respondent engaged in improper professional conduct, violated Section 10A(a)(1) of the Exchange Act, and was a cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder.

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3 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

B. RESPONDENT

3. **Todd D. Chisholm** is a certified public accountant licensed in the state of Utah. He became an audit partner at a predecessor of Chisholm, Bierwolf, Nilson and Morrill, LLC ("Chisholm Bierwolf") in 1995, and he served as the firm's managing partner from 2004 to 2010. Chisholm was the engagement partner on the audits and quarterly reviews of Powder River from 2004 through the third quarter of 2007, and supervised Chisholm Bierwolf's engagements to audit and review Powder River's financial statements throughout that period.

C. RELEVANT ENTITIES

4. **Powder River Petroleum International, Inc.** is an Oklahoma corporation headquartered in Calgary, Canada. The company's common stock is registered with the Commission pursuant to Exchange Act Section 12(g). Powder River's shares are currently quoted on Pink OTC Markets, Inc. In July 2008, an Oklahoma district court granted a temporary restraining order and appointed a receiver for Powder River in connection with a complaint filed by certain Asian investors.[4] In December 2008, Powder River filed for bankruptcy.[5] It has not restated its financial statements, other than a restatement of its 2007 quarterly financial statements included in its year-end 2007 financial statements, nor has it filed any reports with the Commission since September 17, 2008.

5. **Chisholm, Bierwolf, Nilson & Morrill, LLC,** a PCAOB-registered audit firm with offices in Bountiful and Layton, Utah, and its predecessors, have been Powder River's auditor since 2001.

D. FACTS

<u>Oil-and-Gas Working Interest Conveyances</u>

6. From year-end 2004 through the first quarter of 2008, Powder River offered and sold working interests in its oil-and-gas leases through an independent sales agent to investors in Singapore, Malaysia and Indonesia. Powder River's contracts with Asian investors provided that they would receive guaranteed payments yielding an annual minimum of 9%, and in some cases more, beginning approximately six months after the date of investment until investors reached the "break-even" point, i.e. when their principal had been repaid (the "guaranteed payments"). Thereafter, investors received lease production payments based on their respective working interests. By the second quarter of 2007, Powder River's guaranteed payments exceeded not only the investors' share of oil-and-gas production revenues, but also Powder River's total production

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4 *See Chang v. Powder River Petroleum Int'l, Inc.* (Okla. Dist. Ct. July 14, 2008) (No. CJ-2008-4855).

5 *See In re Powder River Petroleum Int'l, Inc.* (Bankr. W.D. Okla. Dec. 12, 2008) (No. 08-15613).

revenues. After that date, Powder River used proceeds from working interest conveyances to new investors to fund guaranteed payments to earlier investors.

7. From year-end 2004 through the first quarter of 2008, Powder River improperly recognized as revenue over $33.5 million in proceeds from conveyances of the working interests to investors. These conveyances were in substance and should have been reported by Powder River as borrowings, not revenue (*see* Financial Accounting Standards No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, paragraph 43). The investors' contractual right to receive guaranteed payments until their "break-even point" represented, in substance, a loan of capital to Powder River at a guaranteed 9% minimum rate of return. As a result of Powder River's improper accounting, the company materially overstated its revenues in its Forms 10-QSB, 10-Q, 10-KSB and 10-K for the year ended December 31, 2004 through the quarter ended March 31, 2008 by 7% to 2,417% and its net pre-tax income by 18% to 441%.

8. Respondent supervised Powder River's audits and quarterly reviews from year-end 2004 through the third quarter of 2007. During Respondent's 2004 and 2005 audits, and his quarterly reviews during 2005 and 2006, Respondent failed to examine the documents underlying the working interest conveyances or to question Powder River's improper revenue recognition of conveyance proceeds. Instead Respondent relied, without further inquiry, on the Powder River CEO's characterization of the working interest conveyances as "sales." As a result, Powder River: a) failed to disclose and account properly for the guaranteed payments; and b) improperly reported the working interest conveyance proceeds as revenue in financial statements included in its 2004 and 2005 Forms 10-KSB and its Forms 10-QSB from the first quarter of 2005 through the third quarter of 2006.

9. During Powder River's 2006 audit, Respondent became aware of Powder River's 9% payments to the working interest investors, but failed to inquire further about them or consider how those payments might affect Powder River's revenue recognition or whether the company should disclose its payment obligation in its 2006 financial statements. As a result, Powder River continued to record the working interest conveyance proceeds as revenue, failed to disclose the guaranteed payments, and improperly offset the guaranteed payments against the company's oil-and-gas production receipts.

10. In the second quarter of 2007, when the guaranteed payments exceeded Powder River's entire oil-and-gas receipts, the company began recording the guaranteed payments on its balance sheet as an asset labeled "pre-paid production payments." Respondent was aware of these facts. Yet, during his 2007 quarterly reviews, Respondent again failed to consider the impact of the guaranteed payments on Powder River's revenue recognition or to inquire further whether Powder River's accounting for those payments was correct. He also failed to consider whether Powder River should disclose its guaranteed payment obligation. As a result of the foregoing, Powder River continued to record the working interest conveyance proceeds as revenue, failed to disclose the guaranteed payments, and mischaracterized those payments as an asset in its financial statements included in its second and third quarter 2007 Forms 10- QSB.

Inflated Assets

11. Powder River reported assets that it did not own or that did not exist in financial statements included in its 2005 and 2006 Forms 10-KSB and its Forms 10-QSB for the first, second and third quarters of 2005 and 2006. During the company's 2005 and 2006 audits, Respondent failed to conduct sufficient audit procedures to support the recorded oil-and-gas assets; otherwise he would have discovered information that indicated a significant amount of such assets should be removed from Powder River's financial statements. As a result, the company overstated its assets by 7% to 40%.

12. In particular, Powder River improperly included as assets in its financial statements two oil-and-gas leases it had agreed, but failed, to acquire. Specifically, in 2005, Powder River made $500,000 in nonrefundable payments as a part of an agreement to acquire a New Mexico oil-and-gas lease for $5 million, but by August 2005 it had defaulted on the terms of the agreement and lost its rights to the lease. Nonetheless, Powder River continued to report the lease as an asset on its balance sheet from the third quarter of 2005 through the first quarter of 2008, which was its last quarterly report. Similarly, Powder River made nonrefundable payments totaling $1.5 million in late 2006 and early 2007 as part of an agreement to acquire a Texas oil-and-gas lease for $6.5 million. The company reported the lease, along with an associated note payable, as assets on its balance sheet from year-end 2006 onward. In reality, the agreement was never consummated, no note agreement was ever executed, and Powder River ultimately forfeited its payments.

13. During Powder River's 2005 and 2006 audits, Respondent failed to review the oil-and-gas lease purchase documents for the New Mexico and Texas leases and to obtain adequate documentation for the $2 million paid to third-parties in the failed lease purchases. During the 2006 audit, Respondent also failed to perform adequate alternate procedures even though: a) documents provided by Powder River to Chisholm Bierwolf indicated the Texas lease purchase agreement terms expired in December 2006; and b) Chisholm Bierwolf received an irregular confirmation of the purported $5 million promissory note.

Failure to Assess the Work of a Professional

14. At year-end 2005 and 2006, oil-and-gas properties represented 62% and 67%, respectively, of Powder River's total assets. In auditing Powder River's 2005 and 2006 financial statements, Respondent obtained and relied upon brief excerpts from oil-and-gas reserve reports. Respondent did little, if anything, to: a) evaluate the qualifications of the petroleum engineer who prepared the oil-and-gas reserve reports; b) understand the nature of the work performed in preparing the oil-and-gas reserve reports; and c) evaluate the petroleum engineer's relationship to Powder River. Prior to the completion of the 2005 audit, Respondent learned that the Commission's Division of Corporation Finance staff had issued comments, some of which addressed Powder River's oil-and-gas reserves, on its 2004 Form 10-KSB, and participated in at least one telephone call regarding the company's response to those comments. Respondent knew or should have known that the staff's comments and Powder River's responses thereto raised questions as to: a) the qualifications of the engineer who prepared the reserve reports; b) the adequacy of the reserve reports to support disclosures made in the financial statements; and c) conformity of the reserve reports with Rule 4-10 of Regulation S-X. Accordingly, Respondent failed to adhere to the guidance contained in AU 336, *Using the Work of a Specialist*, and failed to obtain sufficient competent evidential matter to support Chisholm Bierwolf's report on Powder River's 2005 and 2006 financial statements.

15. Powder River's year-end 2005 and 2006 financial statements disclosed supplementary, unaudited footnote information required under Statement of Financial Accounting Standards No. 69, *Disclosures about Oil and Gas Producing Activities.* Despite the questions raised by the staff's comments on Powder River's 2004 Form 10-KSB, Respondent failed to comply with the provisions of AU §9558, *Required Supplementary Information; Auditing Interpretation of Section 558,* while supervising Powder River's 2005 and 2006 audits. AU §9558 states that if an auditor believes that information may not be presented within the applicable guidelines he ordinarily should make additional inquiries. Respondent had reason to believe that Powder River's footnote information may not have been presented within applicable guidelines. Therefore, he ordinarily should have made additional inquiries, but failed to do so.

Creation of Audit Documents

16. Prior to a PCAOB inspection in 2007, Respondent created and back-dated or directed Chisholm Bierwolf's staff to create and back-date audit planning and other documents more than 45 days after the documentation completion dates for the 2006 audit of Powder River's financial statements. Respondent and his firm's staff failed to document in the workpapers the dates that these changes were made, the names of the persons who made them, and the reasons for adding information. They also failed to notify the PCAOB inspection team that changes had been made to the audit files without appropriately documenting the date of those changes. As a result, Respondent failed to comply with PCAOB Auditing Standard No. 3, *Audit Documentation*, in addition to violating PCAOB rules. Respondent produced those documents to SEC staff during its investigation, without disclosing that they had been back-dated or created after document completion deadlines.

Failure to Conduct Audits in Accordance with PCAOB Standards

17. As the foregoing conduct demonstrates, Respondent failed to conduct Powder River's 2004, 2005, and 2006 audits in accordance with PCAOB Standards and Rules. Specifically, Respondent failed to:

a. Adequately plan audits and properly supervise assistants, under AU 311, ¶8, *Planning & Supervision*;

b. Gather sufficient competent evidential matter, under AU 326, ¶13, *Audit Evidence*, to support the characterization of Powder River's revenue and his conclusions on company assets;

c. Exercise due professional care and skepticism, under AU 230, ¶¶9, 25, *Due Professional Care in the Performance of Work*, as illustrated by repeated failures to review underlying documentation, undue reliance on management, and failure to respond appropriately to "red flags;"

d. Consider whether, under AU 336, ¶¶8, 9, *Using the Work of a Specialist*, Powder River's petroleum engineers possessed the necessary qualifications for their work to be used as audit evidence;

e. Make additional inquiries under AU §9558, *Required Supplementary Information; Auditing Interpretation of Section 558*, although Respondent had reason to believe that Powder River's oil-and-gas reserves footnote information may not have been presented within applicable guidelines; and

f. Properly prepare audit documentation, under PCAOB Auditing Standard No. 3, ¶15, *Audit Documentation*, as demonstrated by after-the-fact creation and back-dating of audit planning documents and checklists at Respondent's direction.

18. Furthermore, Respondent did not have procedures in place designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on Powder River's financial statement amounts, as required by Section 10A(a)(1) of the Exchange Act. This was demonstrated by Respondent's failure to recognize Powder River's improper revenue recognition, his failure to identify assets improperly included on its balance sheet, and his reliance on non-SEC compliant reserve reports that failed to support Powder River's reported reserves.

E. VIOLATIONS

19. Exchange Act Section 10A(a)(1) requires each audit to include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts. No showing of *scienter* is necessary to establish a violation of Section 10A. *See SEC v. Solucorp Indus., Ltd.*, 197 F. Supp. 2d 4 (S.D.N.Y. 2002).

20. As discussed above, Respondent violated Section 10A(a)(1) by failing to have adequate procedures in place during Powder River's 2004, 2005 and 2006 audit to reasonably assure detection of illegal acts, such as Powder River's material overstatement of its revenues, its undisclosed guaranteed payments, its inclusion of improperly recorded assets on its balance sheet, and its materially overstated oil-and-gas reserves, which materially affected the determination of financial statement amounts.

21. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder, require every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission information, documents, and annual and quarterly reports as the Commission may require, and mandate that periodic reports contain such further material information as may be necessary to make the required statements not misleading. The obligation to file such reports 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), *cert. denied*, 440 U.S. 913 (1979).

22. As discussed above, from year-end 2004 through the third quarter of 2007, Respondent's failures were a cause of Powder River's filing of false and misleading quarterly and annual reports with the Commission. Accordingly, Respondent was a cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder.

23. Rule 102(e)(1)(ii) of the Commission's Rules of Practice and Section 4C of the Exchange Act authorize the Commission to censure or deny, temporarily or permanently, the privilege of appearing or practicing before the Commission to accountants who are found to have engaged in improper professional conduct. Under Rule 102(e)(1)(iv), the term "improper professional conduct" means, in part, "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." Respondent's actions were unreasonable and failed to conform to applicable professional standards. Accordingly, his conduct supports an action under Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Rules of Practice.

F. FINDINGS

24. Based on the foregoing, the Commission finds that Respondent violated Section 10A(a)(1) of the Exchange Act, and was a cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder.

25. Based on the foregoing, the Commission finds that Respondent engaged in improper professional conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice.

G. UNDERTAKING

26. **Cooperation**. Respondent undertakes to cooperate fully with the Commission with respect to any matter relating to the Commission's investigation of Powder River or its current or former officers, directors, employees, or auditors, including but not limited to any litigation or other proceeding related to or resulting from that investigation. Such cooperation shall include, but is not limited to, upon reasonable notice and without subpoena:

a. Producing any document, record, or other tangible evidence reasonably requested by Commission staff in connection with the Commission's investigation, litigation or other proceedings;

b. Providing all information reasonably requested by Commission staff in connection with the Commission's investigation; and

c. Attending and providing truthful statements at any meeting, interview, testimony, deposition, trial, or other legal proceeding reasonably requested by the Commission staff.

27. In determining whether to accept the Offer, the Commission has considered these undertakings.

IV.

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

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

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 10A(a)(1) of the Exchange Act.

B. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder.

C. Respondent is denied the privilege of appearing or practicing before the Commission as an accountant.

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

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

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

a. Respondent, or the public accounting firm with which he is associated, is registered with the PCAOB 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 PCAOB and that inspection did not identify any criticisms of or potential defects in 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 PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (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 PCAOB, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

E. 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
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 EXCHANGE ACT OF 1934
Release No. 64280 / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3267 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14336

In the Matter of CHISHOLM, BIERWOLF, NILSON & MORRILL, LLC Respondent.	ORDER INSTITUTING PUBLIC 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 against Chisholm, Bierwolf, Nilson & Morrill, LLC ("Respondent") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

1 Section 4C provides, in relevant part, that:

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) provides, in pertinent part, that:

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to 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:

A. SUMMARY

1. From year-end 2004 through the first quarter of 2008, Powder River Petroleum International, Inc. ("Powder River" or "the company") improperly accounted for over $43 million in proceeds from conveyances of fractional working interests in oil-and-gas leases to investors in Asia. In particular, Powder River immediately recognized revenue from the conveyances, despite the fact that it had promised the Asian working interest investors a guaranteed return until they recouped their initial investment. In addition, Powder River also improperly recorded assets it did not own or that were stated in excess of net realizable value. As a result, Powder River's financial statements did not present fairly, in all material respects, the company's financial position, operating results, and cash flows in conformity with generally accepted accounting principles. Powder River materially overstated its revenues by 7% to 2,417%, its pre-tax income by 18% to 441%, and its assets by 7% to 48% in its Commission filings during the applicable period.

2. From year-end 2004 through the first quarter of 2008, Powder River engaged Respondent to conduct annual audits and quarterly reviews of Powder River's financial statements. Respondent failed to conduct these engagements in accordance with Public Company Accounting Oversight Board ("PCAOB") Standards. Respondent also failed to have procedures in place to detect fraud and to evaluate Powder River's ability to continue as a going concern. Respondent's failures as Powder River's auditor were a cause of Powder River's filing of false and misleading Forms

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The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

[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.

10-QSB and 10-KSB. Accordingly, Respondent engaged in improper professional conduct, violated Sections 10A(a)(1) and 10A(a)(3) of the Exchange Act, and was a cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder.

B. RESPONDENT

3. **Chisholm, Bierwolf, Nilson & Morrill, LLC** ("Chisholm Bierwolf"), a PCAOB-registered audit firm with offices in Bountiful and Layton, Utah, and its predecessors, have been Powder River's auditor since 2001.

C. RELEVANT INDIVIDUALS AND ENTITY

4. **Todd D. Chisholm** ("Chisholm") is a certified public accountant licensed in the state of Utah. He became an audit partner for Respondent in 1995, and he served as the firm's managing partner from 2004 to 2010. Chisholm was the engagement partner on the audits and quarterly reviews of Powder River from 2004 through the third quarter of 2007, and supervised Respondent's engagements to audit and review Powder River's financial statements throughout that period.

5. **Troy F. Nilson** ("Nilson") is a certified public accountant licensed in the state of Utah and has been an audit partner of Respondent from 2004 to the present. Nilson was the engagement partner on Powder River's audit and quarterly review for year-end 2007 and the first quarter of 2008, and supervised Respondent's engagements to audit and review Powder River's financial statements in those periods.

6. **Powder River Petroleum International, Inc.** is an Oklahoma corporation headquartered in Calgary, Canada. The company's common stock is registered with the Commission pursuant to Exchange Act Section 12(g). Powder River's shares are currently quoted on Pink OTC Markets, Inc. In July 2008, an Oklahoma district court granted a temporary restraining order and appointed a receiver for Powder River in connection with a complaint filed by certain Asian investors.[4] In December 2008, Powder River filed for bankruptcy.[5] It has not restated its financial statements, other than a restatement of its 2007 quarterly financial statements included in its year-end 2007 financial statements, nor has it filed any reports with the Commission since September 17, 2008.

D. FACTS

Oil-and-Gas Working Interest Conveyances

7. From year-end 2004 through the first quarter of 2008, Powder River offered and sold working interests in its oil-and-gas leases through an independent sales agent to investors in

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4 *See Chang v. Powder River Petroleum Int'l, Inc.* (Okla. Dist. Ct. July 14, 2008) (No. CJ-2008-4855).

5 *See In re Powder River Petroleum Int'l, Inc.* (Bankr. W.D. Okla. Dec. 12, 2008) (No. 08-15613).

Singapore, Malaysia and Indonesia. Powder River's contracts with Asian investors provided that they would receive guaranteed payments yielding an annual minimum of 9%, and in some cases more, beginning approximately six months after the date of investment until investors reached the "break-even point," i.e. when their principal had been repaid (the "guaranteed payments"). Thereafter, investors received lease production payments based on their respective working interests. By the second quarter of 2007, Powder River's guaranteed payments exceeded not only the investors' share of oil-and-gas production revenues, but also Powder River's total production revenues. After that date, Powder River used proceeds from working interest conveyances to new investors to fund guaranteed payments to earlier investors.

8. From year-end 2004 through the first quarter of 2008, Powder River improperly recognized as revenue over $33.5 million in proceeds from conveyances of the working interests to investors. These conveyances were in substance and should have been reported by Powder River as borrowings, not revenue (*see* Financial Accounting Standards No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, paragraph 43). The investors' contractual right to receive guaranteed payments until their "break-even point" represented, in substance, a loan of capital to Powder River at a guaranteed 9% minimum rate of return. As a result of Powder River's improper accounting, the company materially overstated its revenues in its Forms 10-QSB, 10-Q, 10-KSB and 10-K for the year ended December 31, 2004 through the quarter ended March 31, 2008 by 7% to 2,417% and its net pre-tax income by 18% to 441%.

9. Respondent Chisholm Bierwolf conducted audits and quarterly reviews of Powder River's financial statements from year-end 2004 through the first quarter of 2008. Chisholm supervised Respondent's audits and quarterly reviews from year-end 2004 through the third quarter of 2007. During Respondent's 2004 and 2005 audits, and quarterly reviews during 2005 and 2006, Chisholm failed to examine the documents underlying the working interest conveyances or to question Powder River's improper revenue recognition of conveyance proceeds. Instead he relied, without further inquiry, on the Powder River CEO's characterization of the working interest conveyances as "sales." As a result, Powder River: a) failed to disclose and account properly for the guaranteed payments; and b) improperly reported the working interest conveyance proceeds as revenue in financial statements included in its 2004 and 2005 Forms 10-KSB and its Forms 10-QSB from the first quarter of 2005 through the third quarter of 2006.

10. During Powder River's 2006 audit, Chisholm became aware of Powder River's 9% payments to the working interest investors, but failed to inquire further about them or consider how those payments might affect Powder River's revenue recognition or whether the company should disclose its payment obligation in its 2006 financial statements. As a result, Powder River continued to record the working interest conveyance proceeds as revenue, failed to disclose the guaranteed payments, and improperly offset the guaranteed payments against the company's oil-and-gas production receipts.

11. In the second quarter of 2007, when the guaranteed payments exceeded Powder River's entire oil-and-gas receipts, the company began recording the guaranteed payments on its balance sheet as an asset labeled "pre-paid production payments." Chisholm was aware of these facts. Yet, during 2007 quarterly reviews, he again failed to consider the impact of the guaranteed payments on Powder River's revenue recognition or to inquire further whether Powder River's accounting for those payments was correct. Chisholm also failed to consider whether Powder River should disclose its guaranteed payment obligation. As a result of the foregoing, Powder River continued to record the working interest conveyance proceeds as revenue, failed to disclose the guaranteed payments, and mischaracterized those payments as an asset in its financial statements included in its second and third quarter 2007 Forms 10- QSB.

12. Nilson supervised Powder River's 2007 audit and first-quarter 2008 review. During the 2007 audit, Nilson examined some of the contracts underlying the working interest conveyances, which described the guaranteed payments, and determined that Powder River's accounting for those payments as an asset was improper. The company filed a Form 8-K on March 17, 2008, which disclosed the guaranteed payments and indicated that the company's second and third quarter 2007 financial statements could not be relied upon. When Powder River filed its 2007 Form 10-K and first- quarter 2008 Form 10-Q, the company disclosed the guaranteed payments as a future commitment in its financial statement footnotes. Nilson failed, however, to consider whether, as a result of the guaranteed payment provisions, the conveyances should have been reported as borrowings rather than sales. As a result, the company continued to improperly report the proceeds from its working interest conveyances as revenues.

13. Furthermore, Nilson was aware that Powder River's guaranteed payments exceeded the company's total oil-and-gas revenues for 2007. Yet, he failed to include a "going concern" paragraph in Chisholm Bierwolf audit opinion, despite substantial reason to doubt that Powder River's future oil-and-gas revenues, which were only $3.3 million in 2007, would be sufficient to cover the $6.1 million of guaranteed payments due in 2008.

Inflated Assets

14. Powder River reported assets that it did not own, that did not exist, or that it should have written in financial statements included in its 2005, 2006 and 2007 Forms 10-KSB and 10-K and for its Forms 10-QSB and 10-Q for the for the first, second and third quarters of 2005, 2006, and 2007 and the first quarter of 2008. During the company's 2005, 2006 and 2007 audits, Respondent failed to conduct sufficient audit procedures to support the recorded oil-and-gas assets and a "loan receivable"; otherwise it would have discovered information that indicated a significant amount of such assets should be removed from Powder River's financial statements. As a result, the company overstated its assets by 7% to 48%.

15. In particular, Powder River improperly included as assets on its financial statements two oil-and-gas leases it had agreed, but failed, to acquire. Specifically, in 2005, Powder River made $500,000 in nonrefundable payments as a part of an agreement to acquire a New Mexico oil-and-gas lease for $5 million, but by August 2005 it had defaulted on the terms of the agreement and lost its rights to the lease. Nonetheless, Powder River continued to report the lease as an asset on its balance sheet from the third quarter of 2005 through the first quarter of 2008, which was its last quarterly report. Similarly, Powder River made nonrefundable payments totaling $1.5 million in late 2006 and early 2007 as part of an agreement to acquire a Texas oil-and-gas lease for $6.5 million. The company reported the lease, along with an associated note payable, as assets on its balance sheet from year-end 2006 onward. In reality, the agreement was never consummated, no note agreement was ever executed, and by the end of 2007 Powder River had forfeited its payments.

16. During Powder River's 2005 and 2006 audits, Chisholm failed to review the oil-and-gas lease purchase documents for the New Mexico and Texas leases and to obtain adequate documentation for the $2 million paid to third-parties in the failed lease purchases. During the 2006 audit, Chisholm also failed to perform adequate alternate procedures even though: a) documents provided by Powder River to Respondent indicated the Texas lease purchase agreement terms expired in December 2006; and b) Respondent received an irregular confirmation of the purported $5 million promissory note.

17. During Powder River's 2007 audit, Nilson failed to perform procedures to verify the existence and ownership of the New Mexico and Texas leases, despite the size of the assets and the fact that the company had not paid any significant development costs or taxes on the properties in 2007. Nilson did not review the oil-and-gas lease purchase documents or any promissory note agreement on the Texas lease. During the 2007 audit, Nilson requested confirmation of the purported $5 million promissory note on the Texas lease, but failed to perform sufficient alternative procedures when the confirmation was not returned.

18. In addition, Powder River listed a $1.2 million item as a "loan receivable" on the company's balance sheet in its 2007 Form 10-K financial statements. In prior periods, this item was reported as a cash or cash equivalent. Despite this unexplained change in accounting treatment and the fact that no payments had ever been made on the loan receivable, Nilson failed to obtain documentation of the purported loan receivable or to perform any procedures to evaluate the collectability of the loan. Further, Nilson failed to identify that the loan receivable had not been disclosed as a related party transaction in compliance with Statement of Financial Accounting Standard No. 57, *Related Party Disclosures*.

<u>Failure to Assess the Work of a Professional</u>

19. At year-end 2005 and 2006, oil-and-gas properties represented 62% and 67%, respectively, of Powder River's total assets. In auditing Powder River's 2005 and 2006 financial statements, Respondent and Chisholm obtained and relied upon brief excerpts from oil-and-gas reserve reports. He did little, if anything, to: a) evaluate the qualifications of the petroleum engineer who prepared the oil-and-gas reserve reports; b) understand the nature of the work performed in preparing the oil-and-gas reserve reports; and c) evaluate the petroleum engineer's relationship to Powder River. Prior to the completion of the 2005 audit, Chisholm learned that the Commission's Division of Corporation Finance staff had issued comments, some of which addressed Powder River's oil-and-gas reserves, on its 2004 Form 10-KSB, and participated in at least one telephone call regarding the company's response to those comments. Chisholm knew or should have known that the staff's comments and Powder River's responses thereto raised questions as to: a) the qualifications of the engineer who prepared the reserve reports; b) the adequacy of the reserve reports to support disclosures made in the financial statements; and c) conformity of the reserve reports with Rule 4-10 of Regulation S-X. Accordingly, Respondent and Chisholm failed to adhere to the guidance contained in AU 336, *Using the Work of a Specialist*, and failed to obtain sufficient competent evidential matter to support Respondent's report on Powder River's 2005 and 2006 financial statements.

20. Powder River's year-end 2005 and 2006 financial statements disclosed supplementary, unaudited footnote information required under Statement of Financial Accounting Standards No. 69, *Disclosures about Oil and Gas Producing Activities*. Despite the questions raised by the staff's comments on Powder River's 2004 Form 10-KSB, Respondent and Chisholm failed to comply with the provisions of AU §9558, *Required Supplementary Information; Auditing Interpretation of Section 558,* while supervising Powder River's 2005 and 2006 audits. AU §9558 states that if an auditor believes that information may not be presented within the applicable guidelines he ordinarily should make additional inquiries. Respondent and Chisholm had reason to believe that Powder River's footnote information may not have been presented within applicable guidelines. Therefore, they ordinarily should have made additional inquiries, but failed to do so.

21. At year-end 2007, oil-and-gas properties represented approximately 82% of Powder River's total assets. The company, however, failed to obtain new or updated reserve reports in 2007, instead relying on the reports that it had used in connection with the 2006 audit. In auditing Powder River's 2007 financial statements, Respondent and Nilson relied on the work performed in the audit of Powder River's 2006 financial statements, without performing procedures to test or verify the scope or adequacy of that prior audit work or the 2006 reserve reports. Respondent and Nilson did nothing to: a) evaluate the qualifications of the petroleum engineer who prepared the oil-and-gas reserve reports; b) understand the nature of the work performed in preparing the oil-and-gas reserve reports; and c) evaluate the petroleum engineer's relationship to Powder River. They knew or should have known that Powder River's failure to obtain new or updated reserve reports raised questions as to: a) the qualifications of the engineer who prepared the reserve reports and b) the adequacy of the reserve reports to support disclosures made in the financial statements. Accordingly, Respondent and Nilson failed to adhere to the guidance contained in AU 336, *Using the Work of a Specialist*, and failed to obtain sufficient competent evidential matter to support Respondent's report on Powder River's 2007 financial statements.

<u>Creation of Audit Documents</u>

22. Prior to a PCAOB inspection in 2007, Chisholm and Nilson created and back-dated and directed Respondent's staff to create and back-date audit planning and other documents more than 45 days after the documentation completion dates for the 2006 audit of Powder River's financial statements. Respondent, Chisholm, and Nilson failed to document in the workpapers the dates that these changes were made, the names of the persons who made them, and the reasons for adding information. They also failed to notify the PCAOB inspection team that changes had been made to the audit files without appropriately documenting those changes. As a result, Respondent failed to comply with PCAOB Auditing Standard No. 3, *Audit Documentation*, in addition to violating PCAOB rules. Respondent produced those documents to SEC staff during its investigation, without disclosing that they had been back-dated or created after the document completion deadlines.

Failure to Conduct Audits in Accordance with PCAOB Standards

23. As the foregoing conduct demonstrates, Respondent failed to conduct Powder River's 2004 through 2007 audits in accordance with PCAOB Standards and Rules. Specifically, Respondent, failed to:

a. Adequately plan audits and properly train and supervise assistants, under AU 311, ¶8, *Planning & Supervision*;

b. Gather sufficient competent evidential matter, under AU 326, ¶13, *Audit Evidence*, to support the characterization of Powder River's revenue and Respondent's conclusions on company assets;

c. Exercise due professional care and skepticism, under AU 230, ¶¶9, 25, *Due Professional Care in the Performance of Work*, as illustrated by repeated failures to review underlying documentation, undue reliance on management, and failure to respond appropriately to "red flags;"

d. Consider whether, under AU 336, ¶¶8, 9, *Using the Work of a Specialist*, Powder River's petroleum engineers possessed the necessary qualifications for their work to be used as audit evidence;

e. Make additional inquiries under AU §9558, *Required Supplementary Information; Auditing Interpretation of Section 558*, although Respondent had reason to believe that Powder River's oil-and-gas reserves footnote information may not have been presented within applicable guidelines;

f. Evaluate, under AU 341, ¶3, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, Powder River's ability to continue as a going concern even though the fact that Powder River's total revenues were significantly less than its guaranteed payment obligations should have raised substantial doubt about its ability to continue as a going concern;

g. Perform sufficient alternative procedures, under AU 330, ¶31, *The Confirmation Process*, when Respondent did not receive proper confirmations of a promissory note and a loan receivable; and

h. Properly prepare audit documentation, under PCAOB Auditing Standard No. 3, ¶15, *Audit Documentation*, as demonstrated by after-the-fact creation and back-dating of audit planning documents and checklists.

24. Furthermore, Respondent did not have procedures in place designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on Powder River's financial statement amounts, as required by Section 10A(a)(1) of the Exchange Act. This was demonstrated by Chisholm and Nilson's failure to recognize Powder River's improper revenue recognition, their failure to identify assets improperly included on its balance sheet, and their reliance on non-SEC compliant reserve reports that failed to support Powder River's reported reserves.

25. Respondent also did not include in the 2007 audit an evaluation of whether there was substantial doubt about the ability of Powder River to continue as a going concern during the ensuing fiscal year, as required by Section 10A(a)(3) of the Exchange Act. This is demonstrated by Nilson's failure to recognize that Powder River's total revenues in 2007 were significantly less than its guaranteed payment obligations for the following year, which should have raised substantial doubt about the company's ability to continue as a going concern.

E. VIOLATIONS

26. Exchange Act Section 10A(a)(1) requires each audit to include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts, and Section 10A(a)(3) requires each audit to include an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year. No showing of *scienter* is necessary to establish a violation of Section 10A. *See SEC v. Solucorp Indus., Ltd.*, 197 F. Supp. 2d 4 (S.D.N.Y. 2002).

27. As discussed above, Respondent violated Sections 10A(a)(1) and 10A(a)(3) by failing to have adequate procedures in place during Powder River's 2004 through 2007 audits to: 1) reasonably assure detection of illegal acts, such as Powder River's undisclosed guaranteed payments (from 2004 through 2006), its material overstatement of its revenues, improperly recorded assets on its balance sheet, its materially overstated oil and gas reserves, and Powder River's payments of later working interest conveyance proceeds to earlier working interest investors, which materially affected the determination of financial statement amounts; and 2) to evaluate whether there was substantial doubt about Powder River's ability to continue as a going concern during the 2007 audit.

28. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder, require every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission information, documents, and annual and quarterly reports as the Commission may require, and mandate that periodic reports contain such further material information as may be necessary to make the required statements not misleading. The obligation to file such reports 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), *cert. denied*, 440 U.S. 913 (1979).

29. As discussed above, from year-end 2004 through the first quarter of 2008, Respondent's failures were a cause of Powder River's filing of false and misleading periodic reports with the Commission. Accordingly, Respondent was a cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder.

30. Rule 102(e)(1)(ii) of the Commission's Rules of Practice and Section 4C of the Exchange Act authorize the Commission to censure or deny, temporarily or permanently, the privilege of appearing or practicing before the Commission to accountants who are found to have engaged in improper professional conduct. Under Rule 102(e)(1)(iv), the term "improper professional conduct" means, in part, "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." Respondent's actions were unreasonable and failed to conform to applicable professional standards. Accordingly, Respondent's conduct supports an action under Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Rules of Practice.

F. FINDINGS

31. Based on the foregoing, the Commission finds that Respondent violated Sections 10A(a)(1) and 10A(a)(3) of the Exchange Act, and was a cause of Powder River's violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder.

32. Based on the foregoing, the Commission finds that Respondent engaged in improper professional conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice.

G. UNDERTAKING

33. **Cooperation**. Respondent undertakes to cooperate fully with the Commission with respect to any matter relating to the Commission's investigation of Powder River or its current or former officers, directors, employees, or auditors, including but not limited to any litigation or other proceeding related to or resulting from that investigation. Such cooperation shall include, but is not limited to, upon reasonable notice and without subpoena:

a. Producing any document, record, or other tangible evidence reasonably requested by Commission staff in connection with the Commission's investigation, litigation or other proceedings;

b. Providing all information reasonably requested by Commission staff in connection with the Commission's investigation; and

c. Attending and providing truthful statements at any meeting, interview, testimony, deposition, trial, or other legal proceeding reasonably requested by the Commission staff.

34. In determining whether to accept the Offer, the Commission has considered these undertakings.

IV.

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

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

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 10A(a)(1) and 10A(a)(3) of the Exchange Act.

B. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 promulgated thereunder.

C. Respondent is denied the privilege of 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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64289A / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3269A / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14339

In the Matter of

Kempisty & Company, CPAs, P.C., Philip C. Kempisty, CPA and John Anthony Rubino, CPA,

Respondents.

CORRECTED
ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, AND NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and that public administrative proceedings be, and hereby are, instituted pursuant to Section 4C(2) and (3)[1] of the Exchange Act and Rule 102(e)(1)(ii) and (iii)[2] of the Commission's Rules of Practice against Kempisty and

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 . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) and (iii) provide, in relevant part, that:
The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before the Commission . . . to any person who is found . . . (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or . . . (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

Company, CPAs, P.C., Philip C. Kempisty and John Anthony Rubino (collectively, "Respondents").

Summary

These proceedings arise out of quarterly reviews and an audit performed by Kempisty & Company, CPAs, P.C. ("Kempisty & Company"), of the financial statements of its client, Kentucky Energy, Inc. ("Kentucky Energy"),[3] for the year ended December 31, 2005. In these financial statements, Kentucky Energy improperly accounted for warrants and convertible notes it had issued to third parties. Kempisty & Company rendered an unqualified report stating that, in the firm's opinion, the financial statements presented fairly the financial position of the company in conformity with[4] generally accepted accounting principles ("GAAP"). In fact, the financial statements were not presented in conformity with GAAP and the resulting errors were material. Moreover, the respondents failed to comply with Public Company Accounting Oversight Board ("PCAOB") auditing standards ("AU")[5] in carrying out the relevant audits and reviews.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

Kempisty & Company, CPAs, P.C. ("Kempisty & Company"), is an audit firm with offices in New York City. It is a public accounting firm registered with the Public Company Accounting Oversight Board. Kempisty & Company was the independent auditor for Kentucky Energy at all relevant times from 2003 until the company dismissed it on February 13, 2009.

Philip C. Kempisty, CPA, 61 ("Kempisty"), is the founding partner and majority shareholder of Kempisty & Company. He has been licensed as a CPA in the state of New York since 1974.

John Anthony Rubino, CPA, 67 ("Rubino"), has been a partner/member in Kempisty & Company since 1989. He is licensed as a CPA in the states of New York and Nevada. Rubino worked for a series of CPA firms in the New York City area before joining Kempisty & Company in approximately 1980.

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3 The company was named Quest Minerals and Mining Corp. during the relevant time.

4 The Kempisty report did contain an explanatory paragraph describing substantial doubt about the entity's ability to continue as a going concern and an emphasis of matter paragraph describing that potential adverse rulings in ongoing litigation could result in a loss of the company's operating assets.

5 "AU" refers to the specific sections of the codification of the American Institute of Certified Public Accountants ("AICPA") professional standards, known as the Statements on Auditing Standards, as issued by the Auditing Standards Board of the AICPA. These standards have been adopted by the PCAOB following passage of the Sarbanes-Oxley Act of 2002 ("SOx"). References in this order are to the standards in effect at the time of the relevant conduct.

B. FACTS

Issuance of convertible notes and warrants by Kentucky Energy

1. Kentucky Energy's 2005 financial statements, like those for the preceding year, were prepared by a consultant to the company. This consultant's father was the Vice President, Secretary and a director of Kentucky Energy. Kempisty and Rubino had no specific knowledge of the consultant's education or experience in accounting but were aware that he was not a CPA.

2. Beginning in 2004 and continuing into 2005, Kentucky Energy obtained a series of loans from third parties evidenced by notes convertible into common stock.[6] As an additional incentive to the lenders, Kentucky Energy issued warrants along with each note. Kentucky Energy's consultant needed to account for warrants for the first time in preparing the company's financial statements for inclusion in its Form 10-KSB for the year ended December 31, 2004. Rubino had never previously dealt with the issue of how to account for warrants or a beneficial conversion feature of a convertible note, both of which are derivatives.

Improper accounting for warrants and beneficial conversion feature

3. Rubino told the consultant that he would need to value the warrants using the Black-Scholes option pricing model. Accordingly, the consultant found a Black-Scholes calculator on the internet. This calculator called for him to fill in variables for the warrants' "equity price," "strike price," "volatility," "riskless interest rate," and "time to maturity," and would then generate a Black-Scholes valuation. For "volatility" and "interest rate," however, the consultant simply inserted the generic numbers provided as an example by the website, rather than calculate the actual volatility of Kentucky Energy stock and determine the real riskless interest rate. In fact, Kentucky Energy's stock price was far more volatile than that listed in the website example.

4. Using this method, the consultant arrived at a value for the warrants issued during the last quarter of 2004. He recorded that value as an expense on the company's statement of operations and sent his draft financial statements to Kempisty & Company.

5. Rubino, however, contacted the consultant and told him that he should have recorded the warrant valuation as an asset on the company's balance sheet, rather than as an expense on its statement of operations, and that he should then have amortized that amount over the life of the underlying convertible notes. Not only was this accounting treatment incorrect, but both Rubino and the consultant ignored the necessity to provide for the beneficial conversion feature of the notes.

6. In fact, accounting for the warrants in accordance with GAAP required that the proper inputs be used in the Black-Scholes option pricing model. Kentucky Energy should have

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[6] One series of notes issued during 2005 was not convertible and one note did not have warrants attached, however.

allocated the loan proceeds first to the notes and the warrants; and then, from the portion allocated to the notes, reallocated that to the notes and the beneficial conversion feature of the notes. The amount of proceeds allocable to the warrants and the beneficial conversion feature would be accounted for as paid-in-capital and as a discount to the face amount of the note. The note should have been recorded net of this discount on the balance sheet and the discount should have been amortized to interest expense in the statement of operations over the life of the notes.

7. Rubino testified that he did not know whether or not the consultant was a CPA, what his accounting background was, or whether he was familiar with GAAP. Even after he decided that the consultant's first set of financial statements was incorrectly prepared, Rubino took no further steps to verify the consultant's competence.

GAAP failures

8. For the first quarter of 2005, using the same methodology established in 2004, the consultant arrived at a value of $15,694,422 for the warrants, and that amount less amortization of $1,881,139, or $13,813,283 was recorded as an asset on the company's balance sheet. In the subsequent quarters of 2005, the consultant continued to calculate the warrant valuation improperly and to record it as an asset which, for each of the first two quarters, amounted to over 60% of Kentucky Energy's total assets. On the company's statements of operations, the warrant amortization expense increased correspondingly, and on its 2005 year-end statement of operations amounted to 70% of Kentucky Energy's net loss. Throughout this period, the consultant continued to fail to consider the effect of the beneficial conversion feature of the promissory notes. The combined valuation of the warrants and the beneficial conversion features should not have exceeded the proceeds the company had received from the notes, which amounted to $1,875,000 at the end of the first quarter and $3,105,000 at the end of 2005, and they should not have been recorded as an asset.

9. For its year ended December 31, 2005, as a result of its improper accounting for the warrants and convertible notes, Kentucky Energy recorded the warrant asset in the amount of $3,097,903 on its balance sheet, reflecting the ensuing quarters' amortization as an expense on its statements of operations. In so doing, the company overstated total assets by 43% and overstated its net loss by 197%. It also materially overstated paid-in capital, retained deficit, shareholders' equity and expenses. This improper accounting was material to balance sheets and statements of operations contained in its quarterly filings for 2005 as well. For example, its assets were overstated by approximately $13.8 million, or 213%, in the financial statements contained in its Form 10-Q for the first quarter of 2005 and its net loss was overstated by approximately 174% for the second quarter of 2005.

Audit and Reviews

10. Kempisty & Company, Kempisty and Rubino conducted quarterly reviews and a year-end audit of Kentucky Energy's financial statements for the 2005 year. In the report filed with the Form 10-KSB filed by the company on May 9, 2006, Kempisty and Co. stated that the financial statement presented fairly the financial position of the company at December 31, 2005.

On these engagements, Rubino was the engagement partner and Kempisty was the concurring review partner. They were the only auditors who worked on this engagement, and in fact were the only partners and auditors in the firm at the time.

PCAOB auditing standards failures by Rubino as the engagement partner

Lack of training and proficiency.

11. Rubino lacked the necessary training and proficiency as an auditor to properly interpret the professional guidance under GAAP having to do with accounting for warrants and convertible notes. The workpapers reflect no analysis to support treating the warrants as assets on Kentucky Energy's balance sheet. Nevertheless, he sought no outside advice on these issues. In fact, Rubino did not realize that in accounting for the warrants he was dealing with derivative instruments requiring a careful analysis for proper accounting.

12. PCAOB auditing standards require that the audit be performed by "a person or persons having adequate technical training and proficiency as an auditor." AU § 210.01. PCAOB Auditing Standards further require that "[t]he auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards . . . ." AU § 230.06.

Failure to exercise due professional care and skepticism and to obtain sufficient competent evidential matter.

13. Rubino also failed to obtain and sufficiently examine, read and understand all of the underlying documents evidencing the note/warrant transactions. The workpapers did not contain copies of all the relevant agreements underlying the convertible note financings. There is no evidence that Rubino evaluated this documentation to understand how the transactions should be accounted for under GAAP.

14. Rubino knew that Kentucky Energy's consultant had limited knowledge of accounting and GAAP, yet he failed to review in sufficient detail the Black-Scholes assumptions and analysis the consultant had used, therefore failing to discover that he had merely used the generic volatility and interest rate numbers off the website rather than obtain the correct numbers for Kentucky Energy.

15. PCAOB auditing standards require that "[d]ue professional care is to be exercised in the planning and performance of the audit and the preparation of the report." AU § 230.01. Among other things, due professional care requires that an auditor exercise professional skepticism, defined as "an attitude that includes a questioning mind and a critical assessment of audit evidence." AU § 230.07. Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. AU § 230.08. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. AU § 230.09.

16. PCAOB auditing standards also require that "[s]ufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." AU § 326.01. To be competent, evidence, regardless of its form, must be both valid and relevant. AU § 326.21. In addition, the auditor should "recognize the possibility that the financial statements may not be fairly presented in conformity with generally accepted accounting principles ..." and should "consider relevant evidential matter regardless of whether it appears to corroborate or contradict the assertions in the financial statements." AU § 326.25. Management representations "are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU § 333.02.

Failure to comply with relevant PCAOB auditing standards regarding auditing of derivatives

17. In fact, PCAOB auditing standards provide specific guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments that are made in an entity's financial statements. AU§ 332. This guidance states that the auditor may need special skills or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities. AU§ 332.05.

18. Rubino failed to, among other things:

- Understand the application of generally accepted accounting principles for assertions about derivatives (AU§ 332.05)
- Understand the determination of fair value of derivatives, including the reasonableness of key assumptions (AU§ 332.05 and AU§ 332.40)
- Alter its risk assessment and audit procedures based on the entity's inexperience with a derivative (AU§ 332.08)
- Obtain evidence supporting management's assertion about fair value of the derivative (AU§ 332.35) and
- Evaluate whether the presentation and disclosure of derivatives are in conformity with generally accepted accounting principles (AU§ 332.49).

Thus, Rubino failed to fulfill his responsibilities under PCAOB auditing standards for auditing those instruments.

PCAOB auditing standards review failures by Rubino as the engagement partner

19. In addition to the audit failures, Rubino failed to comply with the specific standards applicable to interim reviews of Kentucky Energy's 2005 quarterly financial statements. These standards, set forth in AU § 722, provide guidance on the nature, timing and extent of the procedures to be performed by an independent accountant when conducting a review of interim financial information.

20. The objective of a review of interim financial information is to provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with GAAP. AU § 722.07. The standards specifically require the accountant to perform certain procedures when conducting a review of interim financial information, including, but not limited to inquiring of management about unusual or complex situations that may have an effect on the interim financial information, and matters about which questions have arisen in the course of applying the review procedures and significant journal entries and other adjustments. AU § 722.18.

21. The unusual or complex situations, referred to in the above paragraph, specifically include the use of derivative instruments and unique terms for debt that could affect classification. AU § 722.55 (Appendix B). Rubino, however, did not give adequate consideration to the analysis and classification of the derivative instruments recorded in the financial statements.

22. Finally, the same standards relating to adequate technical training and proficiency, due professional care and professional skepticism apply to reviews as well as audits. AU § 722.01. Therefore, Rubino's audit failures for Kentucky Energy's year ended 2005 apply equally to the quarterly reviews.

PCAOB auditing standards failures by Kempisty as the concurring review partner

23. Kempisty, as the concurring review partner, was responsible for performing an objective review of significant auditing, accounting, and financial reporting matters that came to his attention, and was an integral part of the resolution of matters prior to the issuance of the firm's audit report. SEC Practice Section ("SECPS") §1000.39 (Appendix E).[7] On the basis of that review, Kempisty was required to conclude that no matters came to his attention that caused him to believe that the financial statements of Kentucky Energy were not in conformity with GAAP in all material respects, and that the firm's audit was performed in accordance with the standards of the PCAOB.

24. Kempisty was required, among other things, to review documentation of the resolution of significant accounting, auditing and financial reporting matters. His review of the financial statements and management documentation should have alerted him to the mistakes in valuing and classifying the warrant.

25. Kempisty had additional specific responsibilities with respect to the concurring review of Kentucky Energy's interim financial statements. For a review conducted on interim financial information on financial statements in an SEC client's quarterly Form 10-Q or 10-QSB filing, a member firm's policies and procedures should require discussion with the concurring partner reviewer, prior to the completion of the review, about any matters identified in the review that involve a significant risk of material misstatement of the financial statements. Any such involvement should be documented. SECPS §1000.39 (Appendix E).

[7] This references concurring partner review standards set by the AICPA which were adopted by the PCAOB following passage of SOx. Kempisty & Company was a member of the SEC Practice Section of the AICPA from 1991until the formation of the PCAOB, making it subject to these standards.

26. Although testimony indicates that Kempisty did discuss the warrant/convertible note accounting issue with Rubino, the workpapers for the interim reviews do not contain any documentation of such discussions nor of matters identified in the review that involve a significant risk of material misstatement of the financial statements.

27. Finally, as a general matter, Kempisty as concurring reviewer was required to have "sufficient relevant technical expertise and experience" to perform his duties. SECPS §1000.39 (Appendix E). In this matter he was therefore required to have technical expertise and experience in the area of accounting for derivatives, including warrants and convertible notes. The standards also require that a concurring reviewer seek assistance from other individuals to supplement his knowledge when necessary.

28. As concurring reviewer for both the interim reviews and year-end audit, Kempisty lacked the expertise and experience necessary to understand that the instruments involved in the transactions were derivatives. He also failed to seek outside professional assistance to understand how to properly account for such items.

Misstatement in Audit Report

29. In this matter, Kempisty & Company, Kempisty and Rubino's audit report falsely states that they conducted their audit in accordance with the standards of the PCAOB, and that in their opinion the financial statements of Kentucky Energy were presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America. In fact, they were not.

C. VIOLATIONS

1. As a result of the conduct described above, Kempisty & Company, Kempisty and Rubino willfully aided and abetted and caused Kentucky Energy's violations of Sections 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and13a-13 thereunder.

2. As a result of the conduct described above, Kempisty & Company, Kempisty and Rubino engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice, and willfully aided and abetted and caused Kentucky Energy's violation of the federal securities laws, pursuant to Section 4C(a)(3) of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

III.

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

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

B. Whether, pursuant to Section 21C of the Exchange Act, Respondents should be ordered to cease and desist from committing or causing any violation and any future violation of Sections 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and13a-13 thereunder; and

C. Whether, pursuant to Section 4C of the Exchange Act and Rule 102(e) of the Commission's Rules of Practice, Respondents should be censured or denied, temporarily or permanently, the privilege of appearing or practicing before the Commission as accountants.

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64288 / April 8, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3268 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14338

In the Matter of **KENTUCKY ENERGY, INC., EUGENE CHIARAMONTE, III AND CLEAR MOUNTAIN ASSOCIATES, LLC,** **Respondents.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Kentucky Energy, Inc., Eugene Chiaramonte, III and Clear Mountain Associates, LLC (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have each submitted an Offer of Settlement (an "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 each of them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

Summary

These proceedings arise out of improper accounting, by Kentucky Energy, Inc., formerly known as Quest Minerals & Mining Corp., for warrants and certain convertible notes for the year ended December 31, 2005. Among other things, Kentucky Energy accounted for warrants it had issued to third parties as an asset with a purported value at the end of the first quarter of 2005 of more than $13 million. This accounting was not in accordance with generally accepted accounting principles ("GAAP") and was material to Kentucky Energy's financial statements, in that it caused its assets to be overstated by 43% and its net loss to be overstated by 197% for the year ended December 31, 2005. The inaccurate financial statements were prepared by Eugene Chiaramonte, III through his consulting company, Clear Mountain Associates, which had been retained by Kentucky Energy for the purpose of preparing its financial statements.

Respondents

1. **Kentucky Energy, Inc.**, formerly known as Quest Minerals & Mining Corp. ("Kentucky Energy") was organized under the laws of the state of Utah in 1985. Since 2004, Kentucky Energy has been in the business of mining coal in Kentucky. It changed its name to Kentucky Energy, Inc. effective June 16, 2010. Kentucky Energy's common stock previously traded on the OTC Bulletin Board under the symbol QMLM.OB and currently trades in the pink sheets under the symbol QMIN.PK and closed at $.0004 on October 4, 2010.

2. **Clear Mountain Associates, LLC**, a New Jersey limited liability company ("Clear Mountain"), has been employed as a consultant to Kentucky Energy from the fall of 2004 to the present. It was formed by Eugene Chiaramonte, III.

3. **Eugene Chiaramonte, III** is the founder and sole owner of Clear Mountain. He has never been licensed as a certified public accountant. Through his consulting firm Clear Mountain, Chiaramonte prepared the financial statements of Kentucky Energy beginning with its quarter ended June 30, 2004, to the present.

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

Background

Inaccurate financial statements.

4. Beginning in the fall of 2004 and continuing throughout 2005, Kentucky Energy obtained a series of loans from third parties, evidenced by notes convertible into common stock. As an additional incentive to the lenders, Kentucky Energy issued warrants along with each convertible note. The way in which Kentucky Energy accounted for these warrants and for the conversion feature of the notes, however, caused its financial statements for the 2005 year to be materially inaccurate.

5. Chairamonte formed Clear Mountain for the purpose of running the Kentucky Energy accounting work, its only client, through an entity. Since mid-2004, Chiaramonte, through Clear Mountain, has been preparing the financial statements of Kentucky Energy and its subsidiaries. He has also been making determinations as to the proper accounting for Kentucky Energy's transactions, because the company has not had an officer or employee capable of working in this area. In these ways, he functioned as the CFO of Kentucky Energy. Chiaramonte was solely responsible for deciding how to account for the warrants and convertible notes issued by Kentucky Energy during 2004 and 2005.

6. All of Kentucky Energy's inaccurate 2005 financial statements were the responsibility of Chiaramonte. He had no prior experience with accounting for warrants, the beneficial conversion feature of a convertible note, or derivative accounting. Chiaramonte consulted the company's audit firm for guidance. He did not seek other outside expertise regarding the proper accounting for the convertible notes and warrants.

7. Kentucky Energy's auditor told Chiaramonte that he should use the Black-Scholes option pricing model to value the warrants. While he had heard the term before, Chiaramonte had no experience with Black-Scholes. He used a search engine to find a Black-Scholes calculator on the internet. This calculator called for inputs for the "equity price," "strike price," "volatility," "rate/year," and "term," and would then generate a figure for "option value." Chiaramonte then applied the resulting valuation to the warrants in Kentucky Energy's financial statements.

8. In using the Black-Scholes calculator he had found on the internet, Chiaramonte did not input the actual volatility and interest rate applicable to Kentucky Energy's common stock. Instead, he chose the generic example for volatility and interest rate provided by the website, and inserted those numbers into the formula. In the case of the volatility figure, Chiaramonte used the generic input suggested by the website, which was 30%, for each quarter in 2005. In fact, the actual volatility of Kentucky Energy's common stock was well in excess of 200% for each quarter. This difference was material.

9. In its 2005 financial statements, Kentucky Energy recorded the warrant valuation as an asset on the company's balance sheet, and amortized that valuation over the life of the

underlying convertible note. In fact, no portion of the loan proceeds represented by the warrants should have been recorded as an asset. Instead, this portion of the loan proceeds should have been recorded in stockholders' equity as paid-in capital, with an offsetting amount treated as a debt discount and amortized. In addition, the company did not account for the beneficial conversion feature of the notes themselves. Kentucky Energy should have allocated the loan proceeds first to the notes and the warrants, and then allocated a portion from the resulting note amount to the beneficial conversion feature of the notes.

10. As a result of this improper accounting, Kentucky Energy's assets were materially overstated for each quarter in 2005 and for the 2005 year. For example, its assets were overstated by approximately $13.8 million, or 213%, in the financial statements contained in the Form 10-Q for the first quarter of 2005.

11. As a result of the amortization of the warrant asset, Kentucky Energy's statement of operations was also materially false for each quarter in 2005 and for the 2005 year. For example, this amortization caused its net loss to be overstated by approximately 174% for the second quarter of 2005.

12. For its year ended December 31, 2005, as a result of its improper accounting for the warrants and convertible notes, Kentucky Energy recorded a warrant asset in the amount of $3,097,903 on its balance sheet, net of that which was amortized as an expense on its statements of operations. In so doing, the company overstated total assets by 43% and overstated its net loss by 197%. Along the way it materially overstated paid-in capital, retained deficit, stockholders' equity and expenses. Its recording of the warrants as an asset, and the subsequent amortization of that asset, was material to both its balance sheet and its statement of operations contained in all of its periodic filings for 2005, and caused those financial statements to be false and misleading.

Violations

13. As a result of the conduct described above, Kentucky Energy committed violations of Section 13(a) of the Exchange Act, which requires registrants to file certain periodic and other reports, and of Rules 12b-20, 13a-1 and 13a-13. Rules 13a-1 and 13a-13 require, respectively, the filing of annual and quarterly reports. Rule 12b-20 provides that, in addition to information specifically required to be included in reports, registrants are obligated to include any material information necessary to make the statements made in the reports not misleading.

14. As a result of the conduct described above, Kentucky Energy committed violations of Section 13(b)(2)(A) and (B) of the Exchange Act. Section 13(b)(2)(A) of the Exchange Act requires every issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act to "make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer . . . ." Scienter is not required to establish a violation of Section 13(b) or the rules thereunder. Section 13(b)(2)(B) requires an issuer to "devise and maintain a system of internal accounting controls sufficient to

provide reasonable assurances that . . . (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets."

15. As a result of the conduct described above, Chiaramonte committed violations of Section 13(b)(5) of the Exchange Act, which provides that "no person shall . . . knowingly falsify any book, record, or account . . ." described in Section 13(b)(2). Chiaramonte knowingly falsified the financial statements of Kentucky Energy by improperly accounting for the warrants and convertible notes.

16. As a result of the conduct described above, Chiaramonte committed violations of Rule 13b2-1 under the Exchange Act, which generally prohibits the falsification of books and records.

17. As a result of the conduct described above, Chiaramonte and Clear Mountain caused Kentucky Energy's violations of Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

Undertakings

18. Kentucky Energy has undertaken to:

a. Maintain at least two independent directors on its Board of Directors so that not less than two-thirds of the members of the Board of Directors will be independent directors;[2]

b. Employ a Chief Financial Officer qualified to prepare financial statements in accordance with GAAP;

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[2] For a director to be considered independent within the meaning of these undertakings, the board must determine that the director has no material relationship with Kentucky Energy (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company) that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. A director is not independent if (1) he is, or has been within the last three years, an employee of the company, or if an immediate family member is, or has been within the last three years, an executive officer of the company; (2) the director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $120,000 in direct compensation from the company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service); (3) the director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of Kentucky Energy's present executive officers at the same time serves or served on that company's compensation committee; or (4) the director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the company, other than those payments to or from the company arising solely from investments in the company's securities or payments under non-discretionary charitable contribution matching programs, for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues. In addition, references to "Kentucky Energy" or "the company" include any parent or subsidiary in a consolidated group with the company.

c. Notify the Division of Enforcement if its chief financial officer resigns or is terminated, or if one or more board members leave the company, such that the board as a whole is no longer independent. Such notification shall be submitted to Karen L. Martinez, Assistant Director, Securities and Exchange Commission, 15 West South Temple Street, Suite 1800, Salt Lake City, Utah 84101, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of such event;

d. Within three months of the date this order is instituted, adopt a system of written internal controls, and identify and implement actions to improve the effectiveness of its disclosure controls and procedures and internal controls, including plans to enhance its resources and training with respect to financial reporting and disclosure responsibilities, and to review such actions with its independent auditors; and

The above undertakings shall automatically expire three years from the date this order is instituted.

IV.

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

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

A. Respondent Kentucky Energy cease and desist from committing or causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

B. Respondent Kentucky Energy comply with its undertakings as enumerated in Section III above. Any undertaking set forth in Section III above which were implemented prior to the date of this Order shall be maintained.

Respondent Kentucky Energy shall certify, in writing, compliance with the undertakings enumerated in Section III above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent Kentucky Energy agrees to provide such evidence. The certification and supporting material shall be submitted to Karen L. Martinez, Assistant Director, Securities and Exchange Commission, 15 West South Temple Street, Suite 1800, Salt Lake City, Utah 84101, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

Any undertakings set forth in Section III above which were implemented prior to the date of this Order shall be maintained.

C. Respondent Chiaramonte cease and desist from committing or causing any violations and any future violations of Section 13(b) (5) of the Exchange Act and Rule 13b2-1 thereunder. Respondents Chiaramonte and Clear Mountain cease and desist from committing or causing any violations and any future violations of Section 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9202 / April 8, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64290 / April 8, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3186 / April 8, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29628 / April 8, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14340

In the Matter of

GUALARIO & CO., LLC and
RONALD GUALARIO,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AND NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Company Act") against Gualario & Co., LLC ("Gualario & Co.") and Ronald Gualario ("Gualario") (collectively, "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

A. SUMMARY

1. These proceedings involve Respondents' fraudulent sale of promissory notes to advisory clients of Gualario & Co., a former registered investment adviser, Respondents' receipt of transaction-based fees in the sale of securities without registration of either Respondent as a broker-dealer, and Respondents' breach of fiduciary duty by failing to disclose to their advisory clients a material change in Respondents' hedge fund investment strategy.

2. Gualario founded Gualario & Co. in 1998 and was its sole principal at all times. In July 2006, Gualario induced an advisory client with limited assets (Client A) to invest a significant portion of her retirement funds in a $100,000 promissory note purportedly issued by a company affiliated with Gualario's cousin ("Company A"). Gualario failed to disclose to Client A that he owed his cousin $50,000 and was recommending the investment to benefit himself. After Client A invested her $100,000, Gualario instructed his cousin to retain $50,000 as repayment of Gualario's debt and to transfer the remaining $50,000 to Gualario. Afterwards, Gualario told Client A that Gualario & Co. would assume responsibility for the note from Company A. Ultimately, Company A and Gualario & Co. failed to repay the note, leaving Client A with a complete loss on her investment.

3. Also in 2006, Respondents raised capital to start a hedge fund. They offered a series of promissory notes, principally to pre-existing advisory clients, and obtained $1.17 million of proceeds (the "Offering"). A subscription agreement prepared by Gualario for the Offering stated that Offering proceeds would be used to launch a hedge fund business and to provide additional working capital. Contrary to these representations, Gualario used a substantial portion of the proceeds for risky options trading in the firm's proprietary account and lost $347,409. Gualario also failed to disclose material information regarding Gualario & Co.'s precarious financial condition. Eventually, Gualario & Co. defaulted on the notes and owes its clients more than $900,000.

4. In August 2007, Respondents launched the SPX Select Hedge Fund (the "Fund"). Gualario raised $7.1 million for the Fund from five pre-existing advisory clients based on his representations that the Fund would follow a conservative trading strategy. When the Fund lost money in September 2007, however, Gualario tried to recoup the Fund's losses by engaging in high-risk options trading, a radical change in investment strategy. In breach of their fiduciary duty to the preexisting advisory clients who invested in this Fund, Respondents failed to disclose the radical change in the Fund's investment strategy. By the end of October 2007, the Fund had lost 98% of its assets as a result of Respondents' high-risk trading.

5. Respondents also arranged for the sale of securities in the form of limited partnership interests in real estate ventures to investors and advisory clients of Gualario & Co. and received at least $89,000 in transaction-based fees in connection with these sales. Gualario & Co. was not registered as a broker-dealer and Gualario was not associated with a registered broker-dealer at the time they engaged in these transactions.

B. RESPONDENTS

6. **Gualario & Co.** is a New York corporation with its principal place of business at Gualario's residence in Basking Ridge, New Jersey. Established in February 1998, Gualario & Co. was registered with the Commission as an investment adviser until August 12, 2009. It served as investment adviser to Gualario's individual clients and to the Fund. Gualario is the founder of Gualario & Co. and has served as its President and CEO since its formation.

7. **Ronald Gualario**, age 44, is a resident of Basking Ridge, New Jersey. He is the founder, President and CEO of Gualario & Co. and the Managing Member of Gualario Capital Partners, LLC, the general partner of the Fund.

C. OTHER RELEVANT ENTITIES

8. **SPX Select Fund** was a hedge fund, organized as a limited partnership under the laws of Delaware in May 2007. It was launched by Gualario & Co. in August 2007. The Fund consisted of a general partner, Gualario Capital Partners, LLC, and five high net worth individual investors, all of whom were pre-existing advisory clients of Gualario & Co. The Fund collapsed in October 2007 and ceased operations in 2008.

9. **Gualario Capital Partners, LLC,** is an affiliate of Gualario & Co. and the general partner of the Fund. It was established by Gualario for the stated purpose of providing managerial services to the Fund. Gualario is the Managing Member and sole owner of Gualario Capital Partners, LLC.

D. MATERIAL MISREPRESENTATIONS AND OMISSIONS IN THE SALE OF A PROMISSORY NOTE TO CLIENT A

10. In 1998, Gualario started Gualario & Co. as an investment adviser providing investment management services to individuals and institutions. From 1998 until 2007, Gualario & Co. grew from one client with $20,000 in assets under management to more than 200 clients with in excess of $40 million in assets under management. Before forming the Fund, Gualario & Co. provided investment advisory services through separately managed accounts using two investment styles: (1) large cap U.S. equities for the discretionary accounts ("Large Cap Accounts"); and (2) investments in promissory notes and real estate for the non-discretionary accounts.

11. In the first half of 2006, Gualario & Co. earned approximately $380,000 in advisory fees. However, Gualario depleted much of this income through high-risk options and day trading activities. The market value of the company's proprietary trading account dropped from approximately $262,000 at the end of June 2006 to $162 at the end of July 2006. As a result, by late July 2006, Gualario & Co. was in a precarious financial condition. It had to meet a margin call of approximately $25,000 in its proprietary trading account. To meet the margin call, on July 24, 2006, Gualario borrowed $25,000 from his cousin, who was a partner at Company A.

12. In late July 2006, Gualario recommended to one of his advisory clients, Client A, that she invest in a $100,000 promissory note purportedly issued by Company A at an interest rate of 12% interest per year. Client A, a retired teacher and recent cancer survivor, had given Gualario her entire savings and retirement funds – approximately $500,000 – to manage. Without the knowledge of Client A, Gualario had structured the transaction to benefit himself by indirectly obtaining money from Client A to repay money he owed to his cousin.

13. Gualario developed a form of promissory note purportedly issued by Company A and an authorization that he asked Client A to execute. The authorization contained the following representation:

> In making my investment decision, I have relied solely on my own examination of this offering including the merits and risks involved. I acknowledge and understand that GUALARIO & CO., LLC ("GUALARIO") is acting solely as the Investment Advisor of my investment funds and have [sic] in no way whatsoever influenced my investment decision other than to act as my Investment Advisor. I also understand that GUALARIO has no business relationship with the sponsor of this investment [Company A]; does not endorse this, or any investment; is not compensated by the investment sponsor; and has no responsibility for the investment nor its results.

14. Client A executed the authorization and authorized Gualario to wire $100,000 from her IRA account to Company A. On August 8, 2006, at Gualario's direction, Gualario's cousin wired $50,000 to Gualario and retained $50,000 as repayment of the $25,000 he had lent Gualario on July 24, 2006 and another $25,000 Gualario owed him.

15. In soliciting Client A to invest in the note, Gualario failed to disclose that the investment was designed to benefit Gualario & Co. and that all of the investment proceeds would inure to the benefit of Respondents. Contrary to the express representations in the authorization, Gualario intended from the outset for Gualario & Co. to assume responsibility for the note. When Gualario discussed the note with his cousin, he told his cousin not to worry -- that Gualario & Co. would be responsible for repayment of the note. Moreover, the authorization's representation that Gualario & Co. had no business relationship with Company A was misleading because Gualario -- Gualario & Co.'s sole principal -- and his cousin -- a partner of Company A -- had prior and existing business relationships in that Gualario had borrowed from and at the time owed $50,000 to his cousin and Gualario structured the transaction to repay this debt.

16. Client A received only a couple of interest payments on the note and did not receive the principal payment when the note became due in August 2007. After unsuccessfully attempting to reach Gualario's cousin, Client A called Gualario, who told her that Gualario & Co. would assume responsibility for the note. On or around January 14, 2008, Gualario sent Client A a letter stating: "Please note that the promissory note issued to you by [Company A] will be assumed by Gualario & Co *(sic)* LLC in February of 2008. I anticipate paying all unpaid interest on the note to your IRA account during that month." By the time Gualario sent the letter to Client A, Gualario & Co. had few assets and owed hundreds of thousands of dollars on promissory notes issued in the

Offering. In addition, the Fund had collapsed after losing approximately $7 million in October 2007. Respondents failed to disclose any of this information to Client A. Gualario & Co. failed to pay the interest or principal owed on the $100,000 note purchased by Client A.

E. FRAUDULENT OFFER AND SALE OF PROMISSORY NOTES TO ADVISORY CLIENTS

17. From September 2006 through November 2007, Respondents conducted the Offering and obtained $1.17 million through the sale of promissory notes issued by Gualario & Co. (the "Notes") to eight investors, most of whom were advisory clients. The Offering purported to raise money to launch a hedge fund.

18. The initial Subscription Agreement prepared by Gualario set a maximum Offering amount of $500,000 and a sunset date of December 31, 2006 for the Offering. With respect to use of proceeds, the Subscription Agreements provided, in pertinent part:

> The Company specializes in institutional and retail investment management services and currently manages approximately $US 40 million of client assets through its Separately Managed Accounts Program ("SMAP"). The Company is in the process of transitioning a portion of its SMAP business to a hedge fund model and believes that such transition will enable it to better serve its existing clients and attract a significant amount of new institutional investors. A successful transition of assets to, and the successful development of, the hedge fund model will require the Company to, incur significant legal and accounting fees, increase staffing (including Chief Compliance Officer and Chief Financial Officer, both of which positions are presently held by Ronald Gualario), retain an outside hedge fund administrator and relocate to larger office space. The Company will use the proceeds of the Offering to meet the expenses related to the above requirements and to provide it with additional working capital. The Company does not anticipate that such expenses will exceed the Maximum Offering Amount.

19. Between September 15 and November 20, 2006, Gualario sold eight Notes totaling $490,000 to six clients. Contrary to the representations in the Subscription Agreements, however, Gualario used virtually none of the $490,000 raised towards the development of the hedge fund business. Shortly after receiving the Offering proceeds, Gualario used $333,500 to engage in options trading in Gualario & Co.'s proprietary trading account and lost almost all of it. In addition, Gualario used approximately $150,000 of the $490,000 to pay for non-hedge fund related expenses, including personal expenses.

20. Having used most of the money he raised between September and November 20, 2006 for options trading and other non-hedge fund-related purposes, Gualario still required money to develop the hedge fund, and he then solicited more of his clients to invest in the Notes. Gualario twice modified the Subscription Agreements to increase the maximum Offering amount and to extend the sunset date. Gualario sold an additional $680,000 in Notes during the later phases of

the Offering. Although Gualario used the bulk of the proceeds raised during the later phases of the Offering for hedge fund expenses, he also used a significant amount for options trading and personal use. In total, Gualario transferred $525,809 of the Offering proceeds to Gualario & Co.'s proprietary account for options trading and lost $347,409.

21. Respondents did not disclose to their clients that they were using Offering proceeds for options trading in Gualario & Co.'s proprietary trading account, rather than to establish the hedge fund.

22. Respondents also did not disclose to their advisory clients that Gualario & Co. was in a precarious financial condition.

23. Between March and August of 2006, only months before the Offering, Gualario transferred close to $300,000 from Gualario & Co.'s business account for his personal use, leaving Gualario & Co. in a precarious financial condition. A few weeks before the Offering, Gualario, on behalf of Gualario & Co., borrowed $75,000 to pay business and personal expenses, including two margin calls totaling $45,000. In early to mid-September 2006, just prior to issuing the first set of Notes, Gualario & Co. had approximately $7,000 in its business account and had issued several checks that bounced.

24. Gualario & Co. defaulted on the Notes and owes approximately $970,000 in principal, plus past due interest.

F. FAILURE TO DISCLOSE MATERIAL CHANGE IN HEDGE FUND TRADING STRATEGY

25. In May 2007, Gualario began soliciting investors for the Fund. Gualario prepared a Private Placement Memorandum ("PPM"), subscription agreements, Limited Partnership Agreements, and a PowerPoint presentation, which were provided to prospective investors. In July 2007, Gualario sent a letter to several prospective investors along with the PPM and a subscription agreement. Gualario also spoke directly with prospective investors. Ultimately, Gualario successfully solicited five existing advisory clients to invest a total of $7,115,154.99 in the Fund. The clients who invested in the Fund continued to retain Gualario & Co. as investment adviser for their separately managed accounts and Respondents continued to render investment advice directly to the clients. Most of the clients who invested in the Fund were at or nearing retirement age and invested retirement money from IRA, 401K and/or pension accounts they held with Gualario.

26. Although the offering materials, including the PPM, contained standard warnings that investment in the Fund was highly speculative and that Respondents might employ a wide range of trading strategies, including high-risk strategies such as options trading and day trading, Respondents represented to investors orally and in writing that the Fund would follow a conservative trading strategy.

27. Gualario conveyed this conservative strategy to prospective investors in written materials and in conversations. The PPM described the investment goal of the Fund as "short-term capital appreciation" regardless of market direction. It stated that the Fund would invest in both

long and short equity positions of select companies that are in the S&P 500 Index. Similarly, Gualario & Co.'s Form ADV indicated that the Fund's investment strategy would be risk averse and would include holding both long and short equity positions of select S&P 500 companies for investment gain and hedging. The Form ADV indicated that the Fund would use essentially the same conservative investment strategy for both the Large Cap Accounts and the Fund, except for a slight variation in the use of margin. Furthermore, Gualario's PowerPoint presented the same strategy and emphasized the goal of reducing volatility. Similar representations were made in a press release issued by Gualario & Co. on August 2, 2007 announcing the launch of the Fund.

28. Both the PowerPoint and press release described the Fund's risk management policies. The PowerPoint stated that the Fund would employ well-established quantitative and qualitative techniques to evaluate and manage the risk inherent in investment activities and further described those risk management guidelines. The press release likewise stated that the Fund would offer portfolio downside protection, employ risk management measures to generate its investment returns and focus primarily on asset protection. The press release also promised that the Fund's investments would be hedged against systemic risk.

29. One client who invested in the Fund ("Client B") specifically asked Gualario whether the Fund would engage in any of the high risk strategies discussed in the PPM and Gualario assured him that it would not. Gualario assured him that the Fund's strategy would be similar to the long-only strategy of the Large Cap Accounts, except that the Fund would have the ability to take short positions for investment gain. Client B, who was about to retire, invested virtually all of his 401(K) retirement savings in the Fund.

30. Respondents launched the Fund on August 8, 2007 and initially followed the conservative strategy that they had represented to their clients. The Fund realized a profit of about 9% for August 2007. However, in September 2007, the Fund incurred a net loss of approximately 20%. Gualario then felt pressure to recoup the losses, particularly from one client, a real estate developer who had indicated that he and his brother might invest tens of millions of dollars with Gualario if the Fund performed well ("Client C"). According to Gualario, Client C called him frequently after the start of the Fund to check on the Fund's performance.

31. To recoup the Fund's September losses, Gualario engaged in high-risk unhedged options trading of individual stocks. Gualario hoped to recoup the losses before he received another call from Client C. Concerned that he would lose his most important client, Client C, if he did not recoup the losses quickly, Gualario continued to engage in massive unhedged options and day trading, putting all of the Fund's assets at high risk of loss.

32. As a result of this high-risk trading strategy, by the end of October, the Fund had lost 98% of its value, leaving it with just $126,328. The impact on most of the clients who invested in the Fund was devastating. Three of the five clients lost a substantial portion of their retirement funds.

33. While Gualario had conversations with his advisory clients who invested in the Fund, he never disclosed the radical change in the Fund's investment strategy until after the Fund had lost almost all its assets.

34. Following the collapse of the Fund, in email communications with his clients, Gualario acknowledged that the Fund was supposed to follow a conservative strategy, that he failed to follow risk management measures, and that he breached his fiduciary duty to his clients in the Fund. In an October 31, 2007 email to clients, Gualario wrote:

> It is with great disappointment and regret that I am informing you that during the month of October, our fund, the Gualario SPX Select Fund, LP, lost 98% of its value. I understand full well my fiduciary responsibilities to you and recognize that I failed you in fulfilling my role.
>
> The fund was intended to be conservative in nature, utilizing a disciplined and well thought out long/short investment strategy. We launched the fund in August during a time of market turmoil and, despite our first months *(sic)* good returns, we were never able to structure the portfolio according to our investment methodology. Following a very disappointing month of September, I pushed harder to make up the prior month's loss. During this time our risk management measures went by the wayside, with particular positions over-weighted, utilization of excessive margin, derivatives left uncovered and a portfolio that resembled nothing like our investment model. As losses mounted our discipline and performance continued to erode.

35. Respondents charged management fees from the Fund, including approximately $4,388 for August 2007, $13,065 for September 2007 and $10,250 for October 2007.

G. FAILURE TO REGISTER AS BROKER-DEALER IN THE SALE OF LIMITED PARTNERSHIP INTERESTS

36. As part of Gualario & Co.'s non-discretionary account management activities, Respondents effected the sale of numerous limited partnership interests to investors without registering with the Commission as a broker-dealer or being associated with a registered broker-dealer. From at least January 2006 through October 2007, Gualario facilitated numerous purchases of limited partnership interests or "Membership Interests" in real estate investments offered by real estate enterprises. These transactions were effected in mostly IRA accounts of clients of Gualario & Co. Respondents served as a middleman in these securities transactions for which they received a one-time fee of the lesser of 1% or $1,000 per transaction. Respondents received at least $89,000 in transaction-based fees from investors for arranging the sale of the limited partnership interests.

H. VIOLATIONS

37. As a result of the conduct described above, Respondents willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities. Respondents violated these provisions in the sale of the promissory note to Client A and in the Offering.

38. As a result of the conduct described above, Respondents willfully violated Section 15(a)(1) of the Exchange Act, which prohibits any entity from making use of the mails or any means or instrumentality of interstate commerce to effect transactions in securities without registering as a broker-dealer or, if a natural person, without being associated with broker-dealer. Respondents violated these provisions in the sale of the limited partnership interests to investors.

39. As a result of the conduct described above, Respondents willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser. Respondents violated these provisions when they sold the promissory note to Client A and the Offering Notes to their clients, and by failing to disclose the material change in the Fund's investment strategy.

40. As a result of the conduct described above, Gualario & Co. willfully violated and Gualario caused and willfully aided and abetted Gualario & Co.'s violation of Section 206(4) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Rule 206(4)-4(a)(1) thereunder, which requires that an investment adviser disclose any financial condition that is likely to impair the adviser's ability to meet its contractual obligations to clients over whose funds the adviser exercises discretionary authority or has custody. Gualario & Co. violated these provisions, and Gualario aided and abetted Gualario & Co.'s violations, by failing to disclose Gualario & Co.'s precarious financial condition to their advisory clients.

III.

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

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

B. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Sections 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Sections 203(e) and 203(f) of the Advisers Act including, but not limited to, disgorgement and civil penalties pursuant to Sections 203(i) and 203(j) of the Advisers Act;

D. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 9(b) of the Company Act;

E. Whether, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act and Section 203(k) of the Advisers Act Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act, Sections 10(b) and 15(a)(1) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-4(a)(1) thereunder and whether Respondent should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act, Section 21C(e) of the Exchange Act and Section 203(j) of the Advisers Act.

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

By: Cathy Ahn
Deputy Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64298 / April 13, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3187 / April 13, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14341

In the Matter of

JAMES J. KONAXIS,

Respondent.

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against James J. Konaxis ("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 and Section 203(f) of 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. Konaxis, age 52, is a resident of Beverly, Massachusetts. Konaxis was associated with Sentinel Securities, Inc. ("Sentinel") from April 2008 through May 2010 as a registered representative. Konaxis also managed advisory accounts for Sentinel's affiliate Sentinel Pension Advisors and from October 2008 through at least May 2010, Konaxis was registered with Massachusetts as an investment adviser representative. Konaxis has Series 7, 63 and 65 licenses.

2. On April 5, 2011, a judgment was entered by consent against Konaxis, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and barring him from participating in an offering of penny stock, in the civil action entitled Securities and Exchange Commission v. James J. Konaxis, Civil Action Number 1:11-cv-10489-DJC, in the United States District Court for the District of Massachusetts.

3. The Commission's complaint alleged that, from approximately May 2008 through April 2010, Konaxis, while associated with registered broker-dealer Sentinel, defrauded one of his largest individual customers, S.T., by repeatedly churning at least three of S.T's brokerage accounts. According to the Commission's complaint, the annualized turnover ratios in three of S.T's accounts were 16, 9, and 8, respectively, from May 2008 through April 2010. The Commission's complaint further alleged that Konaxis disregarded S.T.'s interests and earned approximately $550,000 in commissions as a result of being the registered representative for all of S.T.'s accounts while Konaxis was associated with Sentinel.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, PL 111-203, July 21, 2010, 124 Stat. 1376, Respondent Konaxis be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

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. 64301 / April 14, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14342

In the Matter of MICHAEL A. PICONE, 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 Michael A. Picone ("Respondent" or "Picone").

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.B.1 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:

A. RESPONDENT

1. Picone, age 45, is a resident of New York, New York. Picone was the chief operating officer of A.B. Watley Group, Inc., a publicly traded holding company that conducts its business through broker-dealer subsidiaries, from December 2002 through August 2003. From August 2003 through 2004, Picone was a consultant to A.B. Watley Group, Inc. Picone held series 7 and 63 licenses.

B. RESPONDENT'S CIVIL INJUNCTION

1. On March 21, 2011, a final judgment was entered by consent against Picone, 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, and from aiding and abetting violations of Section 15(c) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. A.B. Watley Group, Inc., et al., Civil Action Number 1:06-CV-1274, in the United States District Court for the Eastern District of New York.

2. The Commission's complaint alleged that, while employed as a consultant and chief operating officer of a broker-dealer, Picone participated in a scheme to improperly obtain material confidential information from broker-dealers' "squawk boxes" so that day traders at the broker-dealer can trade ahead of the broker-dealers' institutional orders.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act that Respondent Picone 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

SECURITIES EXCHANGE ACT OF 1934
Release No. 64297 / April 13, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14187

In the Matter of MICHEL-JEAN GERAUD, Respondent.	ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

On January 12, 2011, 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 Michel-Jean Geraud ("Respondent" or "Geraud").

II.

In connection with these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.B 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:

A. From March 2008 through July 2008, Geraud was the operating manager and controlled the day to day operations of GPS Management, Inc. ("GPS Management"), a telemarketing company engaged in the offer and sale of membership interests, or shares, known as

Units, in Petroleum Unlimited, LLC and Petroleum Unlimited II, LLC (collectively "Petroleum Unlimited"). Geraud, indirectly through telemarketers he managed, solicited investors to purchase Petroleum Unlimited securities in exchange for sales commissions. Geraud trained the sales agents and monitored their calls as they pitched the investment. He also provided leads for them to cold call. Geraud received a portion of GPS Management's receipts, which were based solely on the offering proceeds from the sales of Units of Petroleum Unlimited. GPS Management has never been registered with the Commission in any capacity. During this period, Geraud was neither registered as a broker-dealer nor associated with a registered broker-dealer. Geraud, 34 years old, is a resident of Lighthouse Point, Florida.

B. On August 24, 2010, Geraud pleaded guilty to one count of conspiracy to commit mail fraud in violation of Title 18 United States Code, Section 371 before the United States District Court for the Southern District of Florida, in United States v. Michael Geraud, Case No.10-cr-80070 (S.D. Fla.). On the same day, he also pleaded guilty to one count of conspiracy to impede, impair, obstruct and defeat the lawful government functions of the IRS. See United States v. Michael Geraud, Case No. 10-cr-60091 (S.D. Fla.). On November 2, 2010, a judgment in each criminal case was entered against Geraud. For each of the counts, he was sentenced to a 60 month prison term followed by three years of supervised release, to run concurrently.

C. The count of criminal information in United States v. Michael Geraud, Case No.10-cr-80070 (S.D. Fla.), for which Geraud was convicted alleged, among other things, that Geraud, in connection with the offer and sale of Petroleum Unlimited's securities, defrauded investors and obtained money and property by, among other things, misrepresenting the company's use of offering proceeds, and failing to disclose exorbitant sales commissions.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b) of the Exchange Act, that Respondent Geraud be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

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.

Respondent be, and hereby is, barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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. 64302 / April 14, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14343

In the Matter of **STEVEN E. MALIN,** **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 Steven E. Malin ("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. Steven E. Malin, age 52, is a resident of New York, New York. From approximately August 1993 through December 1996, Malin was employed as a consultant at A.B. Watley Group, Inc., the parent company of A.B. Watley, Inc., a day trading firm registered with the Commission as a broker-dealer. From approximately May 1996 through the present, Malin wâs CEO and Chairman of the Board of A.B. Watley Group, Inc. During the time in which he engaged in the conduct underlying the civil action referenced below, Respondent was associated with a broker-dealer.

2. On March 21, 2011, a final judgment was entered by consent against Steven E. Malin, 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, and from aiding and abetting violations of Section 15(c) of the Exchange Act in the civil action entitled Securities and Exchange Commission v. A.B. Watley Group, Inc., et al., Civil Action Number 1:06-CV-1274, in the United States District Court for the Eastern District of New York.

3. The Commission's complaint alleged, inter alia, that while Steven E. Malin was associated with a broker-dealer, he participated in a scheme to improperly obtain material confidential information from broker-dealers' "squawk boxes" so that day traders at the broker-dealer can trade ahead of the broker-dealers' institutional orders.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act that Respondent Steven E. Malin be, and hereby is barred from association with any broker or dealer, with the right to reapply for association after 1 year 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

COMMODITY FUTURES TRADING COMMISSION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-64314; File No. 4-625]

Joint Public Roundtable on Issues Related to the Schedule for Implementing Final Rules for Swaps and Security-Based Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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

ACTION: Notice of roundtable discussion; request for comment.

SUMMARY: On Monday, May 2, 2011, and Tuesday, May 3, 2011, commencing each day at 9:30 a.m. and ending at 4:00 p.m., staff of the Agencies will hold a public roundtable meeting at which invited participants will discuss various issues related to the schedule for implementing final rules for swaps and security-based swaps under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The discussion will be open to the public with seating on a first-come, first-served basis. Members of the public may also listen to the meeting by telephone. Call-in participants should be prepared to provide their first name, last name and affiliation. The information for the conference call is set forth below.

- U.S. Toll-Free: (866) 844-9416
- International Toll: information on international dialing can be found at the following link: http://www.cftc.gov/PressRoom/PressReleases/internationalnumbers021811.html
- Conference ID: 1212444

A transcript of the public roundtable discussion will be published at http://www.cftc.gov/PressRoom/Events/2011/index.htm. The roundtable discussion will take place each day in the Conference Center at the CFTC's headquarters, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: The CFTC's Office of Public Affairs at (202) 418-5080 or the SEC's Office of Public Affairs at (202) 551-4120.

SUPPLEMENTARY INFORMATION: The roundtable discussion will take place on Monday, May 2, 2011, and Tuesday, May 3, 2011, commencing each day at 9:30 a.m. and ending at 4:00 p.m. Members of the public who wish to comment on the topics addressed at the discussion, or on any other topics related to the schedule for implementing final rules for swaps and security-based swaps under the Act, may do so via:

- Paper submission to David Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581, or Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; or
- Electronic submission via visiting http://comments.cftc.gov/PublicComments/CommentForm.aspx?id=1000 and submitting comments through the CFTC's website; and/or by email to rule-comments@sec.gov (all emails must reference the file number 4-625 in the subject field) or through the comment form available at: http://www.sec.gov/rules/other.shtml.

All submissions will be reviewed jointly by the Agencies. All comments must be in English or be accompanied by an English translation. All submissions provided to either Agency in any electronic form or on paper will be published on the website of the respective Agency, without review and without removal of personally identifying information. Please submit only information that you wish to make publicly available.

By the Commodity Futures Trading Commission.

David A. Stawick
Secretary

April 20, 2011

By the Securities and Exchange Commission.

Elizabeth M. Murphy
Secretary

April 20, 2011

Concurring Statement of CFTC Commissioner Scott D. O'Malia

Implementation Roundtable Seriatim

Certainty & Transparency

I concur in supporting the Commission's roundtable on the implementation process.

Along with the Chairman, I believe that our entire rulemaking process should be as transparent as possible to the public. Consequently, after the Roundtable is complete, I strongly recommend that the Commission submit both a proposal on the order in which the Commission will consider final rulemakings and a proposed implementation plan to the federal register to allow the public to comment before we begin to consider final rules. Once we receive and review comments, a final rulemaking and implementation schedule should be published in the federal register. This level of transparency will give the market a clear picture of how the Commission intends to proceed, and how we can be held accountable as we undertake this massive regulatory overhaul. It will also provide the market with certainty market participants need to make the critical investment decisions necessary to be in compliance with the rules upon implementation. Finally, this type of transparency will help guide the Commission's decision regarding when to make critical investments in advanced technology that are necessary for us to effectively oversee the futures, options, and swaps markets.

The more thoughtful, deliberate, and transparent our sequencing and implementation processes are, the more orderly this Commission's regulation of the swaps market will be.

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64317 / April 20, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3188 / April 20, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14230

In the Matter of

TORREY PINES SECURITIES, INC.

Respondent.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to enter this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Torrey Pines Securities, Inc. ("Torrey Pines" or "Respondent").

II.

Following the institution of these proceedings on February 3, 2011, Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, 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 and Section 203(e) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

These proceedings arise out of Torrey Pines' failure reasonably to supervise Dennis Lee Keating II ("Keating") in connection with an unregistered private securities offering from August 2006 to November 2008. During this time, Keating was associated with Torrey Pines, a registered broker-dealer and state-registered investment adviser. Keating violated Section 15(a) of the Exchange Act, the broker-dealer registration provision of the federal securities laws, by conducting the unregistered private securities offering outside the scope of his employment with Torrey Pines.

Torrey Pines failed reasonably to supervise Keating because the firm did not establish reasonable policies and procedures to assign responsibility for supervising Keating, causing Keating to supervise himself. Torrey Pines also failed to develop systems to implement the firm's procedures regarding outside business activities by registered representatives. As a result, Torrey Pines failed reasonably to supervise Keating within the meaning of Section 15(b)(4)(E) of the Exchange Act and Section 203(e) of the Advisers Act.

Respondent

1. **Torrey Pines Securities, Inc.** is a broker-dealer headquartered in Del Mar, California. Torrey Pines has been registered as a broker-dealer with the Commission since 1985 (File No. 8-35004). Torrey Pines has also been registered in California and Nevada as an investment adviser since 2001 and 2007, respectively.

Other Relevant Person

2. **Dennis Lee Keating, II**, age 46, resides in Highland, Utah. In April 2006, Keating became part-owner and a registered representative of Torrey Pines, working in and supervising the Corona, California branch office. Keating resigned from Torrey Pines in November 2008, and sold his ownership interest. Keating was permanently enjoined on June 28, 2010 for violations of the securities and broker-dealer registration and antifraud provisions, specifically Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder. *SEC v. Dennis Lee Keating, II*, Case No. 2:10cv419 (Dist. Utah filed May 6, 2010), Litigation Release No. 21520 (May 6, 2010). The Commission also barred Keating from associating with a broker-dealer or investment adviser. *Dennis Lee Keating, II*, Exchange Act Release No. 62456 (July 6, 2010).

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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.

Keating's Unregistered Offering

3. Keating joined Torrey Pines in April 2006, opening the Torrey Pines Corona, California branch office (the "Corona Office") where he had overall supervisory responsibility.

4. In August 2006, Keating formed a privately-held company, and until April 2007, he raised over $17 million from friends, family, and Torrey Pines's customers in a private, unregistered offering of securities. Until at least November 2008, Keating also continued lulling investors with false assurances that they would receive a return on their investments. Keating acted as an unregistered broker-dealer in violation of Section 15(a) of the Exchange Act, as he conducted the offering outside the scope of his employment with Torrey Pines.

Torrey Pines Failed To Establish Reasonable Supervisory Procedures And Systems

5. Torrey Pines failed to establish reasonable policies and procedures to assign responsibility for supervising Keating. When Keating became a part-owner of Torrey Pines, Torrey Pines did not revise its written supervisory procedures manual or create other policies or procedures for Keating to be supervised reasonably at the firm's Corona Office. No one other than Keating oversaw the daily activities of the Corona Office. No one reviewed Keating's daily correspondence or telephone calls, other than in cursory annual audits. The delegation of the Corona Office's daily responsibilities to Keating resulted in Keating supervising himself. If Keating had not been left to supervise himself, his outside sales activities, which violated Section 15(a) of the Exchange Act, likely would have been detected.

6. Although Torrey Pines had a policy prohibiting selling securities outside of the firm, and a policy for registered representatives to report outside business activities, the firm failed to develop systems for supervisors and the compliance department to monitor for adherence with the provisions, e.g., reviewing documents relating to registered representatives' outside business activities to ensure that the activities did not involve selling any private securities transactions outside the scope of a representative's employment in violation of Section 15(a) of the Exchange Act. If Torrey Pines had established systems providing for better monitoring for adherence with those provisions, a supervisor or the compliance officer would reasonably have been expected to detect that Keating's outside investment business involved a private, securities-related offering and that Keating violated Section 15(a) of the Exchange Act by conducting this activity without registering as a broker-dealer.

7. From August 2006 through January 2008, a number of suspicious events concerning Keating's outside business activities came to the attention of supervisors and/or compliance staff at Torrey Pines in various ways, including through oral and written complaints to Torrey Pines from an individual who had invested in Keating's private offering. If Torrey Pines had put procedures and systems in place requiring supervisors or the compliance officer to

follow-up on suspicious activities that might signal violations of the firm's prohibition against selling securities outside the firm, Torrey Pines might have prevented and detected Keating's violations of Section 15(a)(1) of the Exchange Act.

Violations

8. As a result of his conduct described above, Keating violated Section 15(a) of the Exchange Act.

9. Section 15(b)(4)(E) of the Exchange Act requires broker-dealers reasonably to supervise persons subject to their supervision, with a view toward preventing violations of the federal securities laws. See, e.g., *Dean Witter Reynolds, Inc.*, Exchange Act Rel. No. 46578 (October 1, 2002). The Commission has emphasized that the "responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." *Id.* Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who "has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision."

10. As a result of the conduct described above, Torrey Pines failed reasonably to supervise Keating within the meaning of Section 15(b)(4)(E) of the Exchange Act, and within the meaning of Section 203(e) of the Advisers Act, when it failed to supervise Keating with a view to detecting and preventing violations of Section 15(a) of the Exchange Act.

Civil Penalties

11. Respondent has submitted a sworn Statement of Financial Condition dated January 31, 2011 and other evidence and has asserted its inability to pay a civil penalty.

Undertakings

Torrey Pines has undertaken to:

12. Retain, not later than 45 days after the date of this Order, at its expense, an independent consultant not unacceptable to the Commission's staff (the "Independent Consultant"). Torrey Pines shall require the Independent Consultant to:

a. Conduct a comprehensive review of Torrey Pines's policies, procedures, and systems with respect to (1) supervision of registered representatives, regardless of ownership interest in the firm; (2) outside business activities of its associated persons (including, but not limited to, procedures and systems to ensure compliance with Section 15(a) of the Exchange Act and NASD Rule 3040) (collectively the "Policies/Systems").

b. Make recommendations for changes or improvements to the Policies/Systems and a procedure for implementing the recommended changes or improvements; and

c. Conduct an annual review, for each of the following two years from the date of the issuance of the Independent Consultant's initial report, to assess whether Torrey Pines is complying with its revised Policies/Systems and whether the revised Policies/Systems are effective in achieving their stated purposes, and make additional recommendations for changes or improvements to the Policies/Systems, if needed.

13. No later than 10 days following the date of the Independent Consultant's engagement, provide to the Commission staff a copy of an engagement letter detailing the Independent Consultant's responsibilities pursuant to paragraph 12 above. To ensure independence, Torrey Pines shall not have the authority to terminate the Independent Consultant without prior written approval of the Commission's staff.

14. Arrange for the Independent Consultant to issue its first report within 90 days after the date of the engagement. For the annual reviews conducted for each of the following two years, arrange for the Independent Consultant to issue each of these reports 365 days following the preceding report. Within 10 days after the issuance of each of the reports, Torrey Pines shall require the Independent Consultant to submit to Diana Tani of the Commission's Los Angeles Regional Office a copy of the Independent Consultant's reports. The Independent Consultant's reports shall describe the review performed and the conclusions reached and shall include any recommendations deemed necessary to make the Policies/Systems adequate and address the deficiencies set forth in Section III of the Order.

15. Within thirty days of receipt of the Independent Consultant's reports, adopt all recommendations contained in the reports and remedy any deficiencies in its written policies, procedures, and systems; provided, however, that as to any recommendation that Torrey Pines believes is unnecessary or inappropriate, Torrey Pines may, within fifteen days of receipt of the reports, advise the Independent Consultant in writing of any recommendations that it considers to be unnecessary or inappropriate and propose in writing an alternative policy or procedure designed to achieve the same objective or purpose.

16. With respect to any recommendation with which Torrey Pines and the Independent Consultant do not agree, attempt in good faith to reach an agreement with the Independent Consultant within thirty days of receipt of the reports. In the event that Torrey Pines and the Independent Consultant are unable to agree on an alternative proposal acceptable to the Commission's staff, Torrey Pines will abide by the original recommendation of the Independent Consultant.

17. Within thirty days after the date of the Independent Consultant's second annual report, submit an affidavit to the Commission's staff stating that it has implemented any and all recommendations of the Independent Consultant, or explaining the circumstances under which it has not implemented such recommendations.

18. Cooperate fully with the Independent Consultant and provide the Independent Consultant with access to its files, books, records and personnel as reasonably requested for the Independent Consultant's review.

19. Require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Torrey Pines, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Los Angeles Regional Office enter into any employment, consultant, attorney-client, auditing or other professional relationship with Torrey Pines, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

20. Within thirty days after the date of the entry of this Order, Torrey Pines shall disseminate, at its own expense, a copy of the Order to all current clients and customers and, for a period of two calendar years starting from the date of the entry of this Order, to all prospective clients and customers, including posting a link to a copy of the Order on the home page, in a readily viewed area, of any and all of Torrey Pines' website(s).

21. Certify, in writing, compliance with each of the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondents agree to provide such evidence. The certification and supporting material shall be submitted to Diana Tani, Assistant Regional Director, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty days from the date of the completion of each of the undertakings.

22. For good cause shown, and upon timely application from Torrey Pines or the Independent Consultant, the Commission's staff may extend any of the procedural dates set forth above.

IV.

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

Accordingly, pursuant to Sections 15(b)(4)(E) of the Exchange Act and Section 203(e) of the Advisers Act it is hereby ORDERED that:

A. Respondent Torrey Pines is censured.

B. Based upon Respondent's sworn representations in its Statement of Financial Condition dated January 31, 2011 and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent.

C. 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.

D. Respondent shall comply with the undertakings enumerated in Section III above.

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
Release No. 64320 / April 21, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14350

In the Matter of SOUTHPEAK INTERACTIVE CORPORATION and PATRICE K. STRACHAN, Respondents.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER AND A CIVIL PENALTY

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 SouthPeak Interactive Corporation ("SouthPeak") and Patrice K. Strachan ("Strachan") (collectively, "the Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers 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, the Respondents 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 a Cease-and-Desist Order and a Civil Penalty ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

A. RESPONDENTS

1. SouthPeak is a video game publisher headquartered in Midlothian, Virginia. SouthPeak's stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is listed on the OTC Bulletin Board under the symbol "SOPK."

2. Patrice K. Strachan, age 53, was at all relevant times SouthPeak's vice president of operations.

B. OTHER RELEVANT PERSON

1. Terry M. Phillips, age 52, is the chairman of SouthPeak's board of directors.

C. SUMMARY

This matter involves an undisclosed related party transaction in which Terry M. Phillips, the chairman of the board of directors of SouthPeak, used personal funds to pay for the purchase of inventory for SouthPeak in February 2009. In violation of SouthPeak's internal policy, Phillips failed to obtain prior approval of the Audit Committee of SouthPeak's board of directors for this related party transaction. Due to the actions of Patrice Strachan, SouthPeak's vice president of operations, SouthPeak's chief financial officer ("CFO") was not informed of this payment and the transaction was not properly recorded on SouthPeak's books and records. As a result, SouthPeak failed to disclose the related party transaction in its quarterly report on Form 10-Q for the quarter ended March 31, 2009, and thereby omitted material facts regarding a decrease in the company's liquidity. Further, in connection with SouthPeak's restatement of its quarterly report, Strachan made false material statements in an interview with SouthPeak's auditor.

D. FACTS

SouthPeak develops and publishes video games for a number of video game platforms, including the PlayStation, xBox, and Wii devices. SouthPeak provides software specifications to hardware vendors that manufacture the video game cartridges that SouthPeak subsequently distributes for retail sale.

In February 2009, SouthPeak ordered additional units of a popular video game from a video game manufacturer (the "Manufacturer"). Given that SouthPeak lacked sufficient funds for

[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 purchase at that time, Phillips advanced funds for the purchase of the units from his personal funds. On February 13, 2009, Phillips' assistant sent a wire transfer of $307,440 from Phillips' personal account to the Manufacturer as payment for 50,400 units of the video game.

After making the wire transfer, Phillips' assistant informed Strachan of the payment from Phillips' personal account. Strachan was responsible for ensuring the proper recording of accounts payable in SouthPeak's books and records. Strachan, however, not only failed to take steps to ensure that the payment was properly recorded, but, after questions were raised internally at SouthPeak concerning the payment, Strachan also instructed her subordinate not to inform the CFO that Phillips had made the payment with his personal funds.

SouthPeak's internal accounting policy, which was in effect during the relevant time, requires that the Audit Committee of SouthPeak's board of directors review and approve all related party transactions. Although Phillips was aware of this policy, he did not bring his proposed payment to the attention of the Audit Committee prior to the transaction. Nor did Phillips ensure that the related party transaction was properly and accurately recorded in SouthPeak's books and records and disclosed in the relevant periodic report.

Despite this, Phillips signed a management letter to SouthPeak's outside auditor representing that all related party transactions had been disclosed for the quarter ended March 31, 2009. Phillips' payment from his personal funds, however, had not been disclosed to the auditor.

SouthPeak's Form 10-Q for the quarter ended March 31, 2009 did not disclose Phillips' payment as a related party transaction. By failing to disclose that SouthPeak utilized Philips' funds to pay for inventory because of a material change in its financial position, SouthPeak omitted material facts from its Form 10-Q for the quarter ended March 31, 2009.

SouthPeak subsequently determined to file an amended quarterly report on Form 10-Q for the quarter ended March 31, 2009. In connection with that restatement, SouthPeak's auditor conducted an interview of Strachan. Strachan falsely claimed during that interview that she never directed her subordinate to conceal information from SouthPeak's CFO.

E. VIOLATIONS

Section 13(a) of the Exchange Act and Rule 13a-13 thereunder require issuers with securities registered under Section 12 of the Exchange Act to file quarterly reports with the Commission on Form 10-Q. These reports must be complete and accurate in all material respects. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978), *cert. denied sub nom. Zimmerman v. SEC*, 440 U.S. 913 (1979). No showing of scienter is necessary to establish a violation of Section 13(a). *Savoy Indus., Inc.*, 587 F.2d at 1167. Exchange Act Rule 12b-20 requires an issuer to include in its periodic reports any "material information . . . necessary to make the required statements, in the light of the circumstances under which they were made[,] not misleading."

Exchange Act Rule 13a-13 requires issuers' quarterly reports to comply with the disclosure requirements of Regulation S-K Item 303. Item 303 requires issuers to include a "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) section in their periodic public filings. Item 303(b) requires issuers' filings to discuss material changes in the items enumerated in Item 303(a). Item 303(a)(1) requires issuers to "identify and separately describe internal and external sources of liquidity . . . ." in the MD&A sections of their public filings. Rule 13a-13 of the Exchange Act further requires issuers' quarterly reports to comply with Regulation S-X. Moreover, Item 4-08(k) of Regulation S-X, titled "Related Party Transactions Which Affect the Financial Statements," provides that "[r]elated party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows." Further, Statement of Financial Accounting Standards No. 57 ("SFAS 57")[2] provides that material related party transactions should be disclosed in financial statements, including the nature of the relationships involved, a description of the transactions, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements. In addition, Rule 10-01(a)(5) of Regulation S-X requires that "interim financial information shall include disclosures either on the face of the financial statements or in the accompanying footnotes sufficient so as to make the interim information presented not misleading."

SouthPeak violated Section 13(a) of the Exchange Act, and Rules 12b-20 and 13a-13 thereunder, when it omitted material facts from its Form 10-Q for the quarter ended March 31, 2009 by failing to disclose that it utilized Philips' funds to pay for inventory because of a material change in its financial position. SouthPeak should have disclosed the related party transaction (1) pursuant to Item 303 of Regulation S-K because it would have revealed a material decrease in the company's liquidity and (2) pursuant to Item 4-08(k) of Regulation S-X and SFAS 57 because it was material to SouthPeak and the information regarding the transaction, and the reason for it, was necessary to an understanding of the effect of the transaction on SouthPeak's financial statements. Additionally, because the related party disclosure in the Form 10-Q disclosed all related party transactions except for Phillips' payment, including related party transactions of lesser amounts than Phillips' payment, the related party disclosure was misleading in violation of Rule 10-01(a)(5) of Regulation S-X.

By failing to accurately record Phillips' payment from his personal funds, SouthPeak failed to make and keep books and records "which, in reasonable detail, accurately and fairly reflect[ed] the transactions and dispositions of the assets of the issuer," and thereby violated Section 13(b)(2)(A) of the Exchange Act.

Further, SouthPeak violated Exchange Act Section 13(b)(2)(B), by failing to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles or any other criteria applicable to such statements.

As a result of the conduct described above, Strachan committed or caused a violation of Rule 13b2-2 under the Exchange Act, which prohibits a director or officer from, directly or indirectly, making materially false or misleading statements, or omitting to state, or causing another person to omit to state material facts necessary in order to make statements made, in light of the circumstances under which they were made, not misleading to an accountant in connection with any audit, review, or examination of the financial statements of an issuer required to be made

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[2] SFAS 57 was in effect at the time of the conduct in question. Subsequently, the provision was codified as Accounting Standards Codification 850.

pursuant to the Exchange Act, or in connection with the preparation or filing of any document required to be filed with the Commission.

Also as a result of the conduct described above, Strachan was a cause of SouthPeak's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder.

IV.

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

Accordingly, pursuant to Sections 21B(a)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent SouthPeak Interactive Corporation cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder.

B. Respondent Patrice K. Strachan cease and desist from causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20 and 13a-13 thereunder, and committing or causing any violations and any future violations of Rule 13b2-2 thereunder.

C. Respondent Patrice K. Strachan shall, within thirty (30) days of the entry of this Order, pay a civil penalty in the amount of $10,000 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, 100 F St., N.E., Stop 6042, Washington, DC 20549-6042; and (D) submitted under cover letter that identifies Strachan 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 Yuri B. Zelinsky, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Stop 5041, Washington, DC 20549-5041.

By the Commission.

Elizabeth M. Murphy
Secretary

Cathy Ahn

By: Cathy Ahn
Deputy Secretary

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64323 / April 22, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3189 / April 22, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29657 / April 22, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14351

In the Matter of **ROBERT DAVID BEAUCHENE,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940**

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"), Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Robert David Beauchene ("Beauchene" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

SUMMARY

1. From approximately August 2005 through July 2007, Beauchene, an unregistered investment adviser, fraudulently raised at least $160,000 from four investors for investment in a purported hedge fund called Rhombus Amalgamated Enterprises, Inc. ("Rhombus").

2. Beauchene represented to prospective investors that, through Rhombus, he had over $10 million assets under management; that he had earned annual returns of 10-20% on his securities trading in the past, and that Rhombus's trading was based on analytical models developed by his partner in Rhombus, an experienced market analyst. Once he received their money, Beauchene repeatedly told the investors that Rhombus was earning positive returns and provided monthly statements to one of them showing hundreds of trades each month and positive returns – including an annual return of 47% for 2006 – for the investor's account with New York-based, registered broker-dealer.

3. Those representations were false. Rhombus did not operate as a hedge fund, did not have any assets other than the approximately $160,000 Beauchene raised from the four investors, and his purported partner – the touted hedge fund expert – was not involved in the management of Rhombus, did not provide any models to Beauchene, and had not authorized Beauchene to use his name to solicit investments in Rhombus. Rhombus had no track record, much less the impressive returns that Beauchene claimed, and was not generating positive returns for the investors – the monthly statements Beauchene provided to one investor were fabricated; the account referenced in the statements did not exist.

4. In reality, Rhombus was nothing more than a series of bank accounts into which Beauchene deposited investor funds, which he then used primarily to pay personal expenses and, to a lesser extent, to trade securities. And the little securities trading Beauchene did was consistently unsuccessful, resulting in losses every month the brokerage account was open, for a total loss of approximately $25,000.

RESPONDENT

5. **Beauchene**, age 43, currently resides in Wilmington, North Carolina. At various times from 1995 through July 2006, Beauchene was a registered representative of one of a series of six registered broker-dealers. At all relevant times, he was an investment adviser as defined by Section 202(a)(11) of the Advisers Act, and from at least February 2006 to July 2006 he was a registered representative of a registered broker-dealer headquartered in Philadelphia, Pennsylvania.

RELATED PERSON

6. **Rhombus** is a New York State corporation formed by Beauchene in December 2002. Its stock is not registered and does not trade on any exchange. Beauchene is the president of Rhombus and its only officer or employee.

FACTS

7. In approximately August 2005, Beauchene solicited Investor A to invest in Rhombus, which he described to the investor as a hedge fund. Beauchene told Investor A that his partner in Rhombus was an experienced market analyst who had sophisticated programs to assist with Rhombus's trading strategy and who regularly appeared on television to talk about hedge fund investing and stock market trends. Investor A invested a total of $60,000 in Rhombus in five installments from August 2005 through July 2007. Once he invested, Beauchene consistently reported to Investor A that Rhombus was achieving positive returns. These positive reports convinced Investor A to repeatedly increase his investment in Rhombus.

8. In or around August 2005, Beauchene solicited Investor B for an investment in Rhombus. He represented to Investor B that Rhombus already managed $10 million and did so using models and research provided by a partner of Beauchene's who had fifteen years of experience providing investment research to hedge funds. In September 2005, Investor B invested $20,000 in Rhombus.

9. In or around July 2006, Beauchene solicited Investor C for an investment in Rhombus. Beauchene told Investor C that he had already raised $10 to $15 million for Rhombus; that Rhombus traded in an account with a New York-based, registered broker-dealer, and that his trading had been very successful. In August 2006, Investor C invested $40,000 in Rhombus. The following month, Investor C began receiving monthly account statements purportedly issued by the broker-dealer for his account with Rhombus. The statements showed hundreds of trades supposedly made each month, the monthly profit or loss, and year-to-date returns. According to those statements, Investor C's account had earned a return of 47% for 2006 and 24% as of June 2007. The account statements Investor C received were fabrications, created by Beauchene who was at one time briefly associated with an affiliate of the broker-dealer.

10. In October 2006, Beauchene solicited Investor D and her husband ('the Ds") for an investment in Rhombus. Beauchene told the Ds that Rhombus already had $10 million under management and that the fund was earning high returns. He also told them that Rhombus typically required a minimum initial investment of $100,000, but he would waive the minimum and permit the Ds invest in $10,000 increments. From November 2006 to May 2007, the Ds invested $40,000 in Rhombus in three installments, at least one of which followed reports by Beauchene that the value of the Ds' investment had already increased by approximately 50%.

11. Beauchene's representations to Investors A, B, C, and the Ds described above were false. Rhombus was not a hedge fund and did not have any assets other than the approximately $160,000 Beauchene raised from the four investors. Beauchene's purported

partner – the touted hedge fund expert – was not involved in the management of Rhombus, did not provide any models to Beauchene, and had not authorized Beauchene to use his name to solicit investments in Rhombus. Rhombus had no history of successful performance, and Beauchene did not use the funds he raised from Rhombus investors to trade in securities on their behalf, much less achieve the positive returns he reported. Instead, Beauchene spent most of the $160,000 he received from investors from August 2005 through July 2007 on personal expenses. Beauchene also lost approximately $25,000 of investors' funds on securities trading; trading that did not correlate in any respect to the trading or performance he reported to the investors.

VIOLATIONS

12. As a result of the conduct described above, Beauchene willfully violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act) and Rule 10b-5, thereunder, and Sections 206(1) and 206(2) of the Advisers Act.

III.

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

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

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

By: Cathy Ahn
Deputy Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64329 / April 22, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14352

In the Matter of **David M. Otto, 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 David M. Otto ("Respondent" or "Otto") 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 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 Rule 102(e)

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

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

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. Otto, age 51, is a resident of Seattle, Washington. He is and has been an attorney licensed to practice in the states of Washington and New York. In 2004, he was hired by Peter Cheung to incorporate and obtain financing for Cheung's company, then called HerbalPharm, and later renamed MitoPharm Corporation ("MitoPharm"). Otto provided advice to Cheung and MitoPharm regarding compliance with the federal securities laws.

2. On July 13, 2009, the Commission filed a complaint against Otto in SEC v. David M. Otto, et al. (Civil Action No. C-09-0960-RAJ) in the United States District Court for the District of Western Washington. On April 11, 2011, the court entered an order permanently enjoining Otto, by consent, from future violations of Section 5 and Section 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77e and 77q(a), and Sections 10(b) and 16(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78p(a), and Rules 10b-5, 16a-3 thereunder, 17 C.F.R. §§ 240.10b-5 and 240.16a-3. The court further enjoined Otto from participating in an offering of penny stock for a period of five (5) years. Otto was also ordered to pay $38,610.18 in disgorgement, and $6,651.18 in prejudgment interest; and a $180,000 civil money penalty.

3. The Commission's complaint alleged, among other things, that Otto participated in a fraudulent scheme through which millions of shares of MitoPharm stock were issued in violation of the registration requirements of the federal securities laws and then were sold to the public at inflated prices based on false information about MitoPharm's business. To facilitate the scheme, the complaint alleged that Otto and his associate drafted a legal opinion letter containing material misstatements, and filed a disclosure with the Pink Sheets quotation service that failed to disclose Otto's ownership interest in MitoPharm while a promotional campaign was underway.

IV.

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

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

A. Otto is suspended from appearing or practicing before the Commission as an attorney.

B. After three (3) years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an affidavit to the Commission's Office of the General Counsel truthfully stating, under penalty of perjury, that he has complied with the Order, that he is not subject to any suspension or disbarment as an attorney by a court of the United States or of any state, territory, district, commonwealth, or possession, and that he has not been convicted of a felony or misdemeanor involving moral turpitude as set forth in Rule 102(e) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary

By: Cathy Ahn
Deputy Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64330 / April 22, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14353

In the Matter of **Todd Van Siclen, 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 Todd Van Siclen ("Respondent" or "Van Siclen") 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 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 Rule 102(e)

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

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

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. Van Siclen, age 40, is a resident of Seattle, Washington. He is and has been an attorney licensed to practice in the states of New Jersey and New York. He is and was an associate at Otto Law Group PLLC, a law firm owned by David M. Otto ("Otto"). In 2004, Otto was hired by Peter Cheung to incorporate and obtain financing for Cheung's company, then called HerbalPharm, and later renamed MitoPharm Corporation ("MitoPharm"). Van Siclen was responsible for the day-to-day work on the MitoPharm engagement.

2. On July 13, 2009, the Commission filed a complaint against Van Siclen in SEC v. David M. Otto, et al. (Civil Action No. C-09-0960-RAJ) in the United States District Court for the District of Western Washington. On April 11, 2011, the court entered an order permanently enjoining Van Siclen, by consent, from future violations of Section 5 and Section 17(a)(3) of the Securities Act of 1933, 15 U.S.C. §§ 77e and 77q(a)(3). The court further enjoined Van Siclen from participating in an offering of penny stock for a period of three (3) years. Van Siclen was also ordered to pay a $10,000 civil money penalty.

3. The Commission's complaint alleged, among other things, that Van Siclen participated in a fraudulent scheme through which millions of shares of MitoPharm stock were issued in violation of the registration requirements of the federal securities laws and then were sold to the public at inflated prices based on false information about MitoPharm's business. To facilitate the scheme, the complaint alleged that Van Siclen forged documents to issue MitoPharm stock, drafted a legal opinion letter filled with material misstatements, filed a disclosure with the Pink Sheets quotation service that failed to disclose Otto's ownership interest in MitoPharm, and participated in a fraudulent promotional campaign.

IV.

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

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

A. Van Siclen is suspended from appearing or practicing before the Commission as an attorney.

B. After one (1) year from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an affidavit to the Commission's Office of the General Counsel truthfully stating, under penalty of perjury, that he has complied with the Order, that he is not subject to any suspension or disbarment as an attorney by a court of the United States or of any state, territory, district, commonwealth, or possession, and that he has not been convicted of a felony or misdemeanor involving moral turpitude as set forth in Rule 102(e) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary

By: Cathy Ahn
Deputy Secretary

Chairman Schapiro
Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64336 / April 25, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14354

In the Matter of **HUNTLEIGH SECURITIES CORPORATION and JEFFREY S. CHRISTANELL,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Huntleigh Securities Corporation and Jeffrey S. Christanell (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

Summary

These proceedings arise from Jeffrey S. Christanell's ("Christanell") execution of unlawful "marking the close" trades at the request of a SEC-registered investment adviser ("Investment Adviser"). During the relevant period, Christanell was employed by Huntleigh Securities Corporation ("Huntleigh"), a broker-dealer registered with the Commission, and the Investment Adviser sent orders on behalf of his advisory clients to Huntleigh. From September through December 2009, Christanell, on behalf of, and at the direction of, the Investment Adviser, "marked the close" in certain thinly-traded securities by executing trades in the final minutes of the last trading day of the month with the intention of artificially affecting the securities' closing prices. In addition, Huntleigh failed reasonably to supervise Christanell by failing to establish procedures or to have a system to implement existing procedures reasonably designed to prevent and detect Christanell's violations of the securities laws.

As a result of the foregoing conduct, Christanell willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Huntleigh failed reasonably to supervise Christanell with a view to preventing him from violating those provisions, within the meaning of Section 15(b)(4)(E) of the Exchange Act.

Respondents

1. Jeffrey S. Christanell, age 40, resides in St. Louis, Missouri. From September 2001 through February 2010, Christanell was employed as Head of Institutional Trading at Huntleigh Securities Corporation in St. Louis, Missouri. He is currently employed as a software salesman. Christanell is registered with FINRA and holds S7, S24, and S63 securities licenses.

2. Huntleigh Securities Corporation, a Missouri corporation with its primary place of business in St. Louis, Missouri, is a broker-dealer registered with the Commission and FINRA since 1977.

Facts

A. Marking-the-Close Transactions

3. From September 2009 through December 2009, the Investment Adviser instructed Christanell to execute trades in order to inflate the prices of certain thinly-traded securities held by the Investment Adviser's clients by placing buy orders at prices well above the most recent previous trade shortly before the markets closed. This trading strategy, known as "marking the

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

close," involves placing orders at or near the close of the market to artificially affect the closing price of a stock.

4. On September 30, 2009, the Investment Adviser instructed Christanell to buy shares of the common stock of issuer High Country Bancorp, Inc. ("HCBC"), which are quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group, Inc. ("OTC Link"), to artificially increase the closing price. In an email, the Investment Adviser told Christanell to buy HCBC shares just before the market close at a price "as near to $25 [per share] as possible without appearing manipulative." At 3:56 p.m. Eastern time, Christanell routed for execution an order to purchase 2,000 shares of HCBC at up to $24.50 per share. The order was partially filled as Christanell bought 1,400 HCBC shares at prices up to $23.99 per share.

5. Christanell's trades for the Investment Adviser were the only trades in HCBC on September 30, 2009. HCBC closed at $23.50 per share, up $5.50 per share or 30.5% from the closing price on September 29. Christanell's purchases of HCBC for the Investment Adviser increased the market capitalization of HCBC by more than $4.9 million, from $16.1 million to $21.0 million.

6. On October 30, 2009, the Investment Adviser again instructed Christanell to buy HCBC shares to artificially increase the closing price. At 3:46 p.m. Eastern time, Christanell routed for execution a market order to buy 600 shares of HCBC. The order was completely filled at prices up to $19.75 per share.

7. Christanell's trades for the Investment Adviser on October 30, 2009 rapidly moved HCBC's price from $14.00 per share to its close at $19.75 per share, up $6.49 per share or 48.9% from the prior closing price on October 29, 2009. Christanell's trades constituted 42.9% of the market volume in HCBC on October 30, 2009. Christanell's purchases for the Investment Adviser increased the market capitalization of HCBC by more than $5.8 million, from $12.5 million to $17.7 million.

8. On November 30, 2009, the Investment Adviser again instructed Christanell to buy HCBC shares to artificially increase the closing price. At 3:57 p.m. Eastern time, Christanell routed for execution an order to buy 1,000 shares of HCBC at up to $21.00 per share. The entire order was filled at $17.00 per share. At 3:58 p.m., seeking a higher closing price, Christanell routed for execution a second order to buy 1,000 shares of HCBC at up to $21.00 per share. The second order was entirely filled at $17.49 per share.

9. On November 30, 2009, HCBC closed at $17.49 per share, up $2.49 per share or 16.6% from the prior closing price on November 27, 2009 (the previous trading day). Christanell's trades for the Investment Adviser were 100% of the market volume in HCBC on November 30, 2009 and moved the market price from $15.00 per share to $17.49 per share. Christanell's purchases for the Investment Adviser increased the market capitalization of HCBC by more than $2.2 million, from $13.4 million to $15.6 million.

10. On December 31, 2009, the Investment Adviser again instructed Christanell to buy HCBC shares to artificially increase the closing price. In a December 23, 2009 email, the Investment Adviser informed Christanell that he "want[ed] to move up HCBC the last day of the

year." In a December 28, 2009 email, the Investment Adviser told Christanell to "[p]lease put on your calendar to buy HCBC 30 minutes to an hour before the close of market for the year. I would like to get a closing price in the 20-25 range, but certainly above 20." In a recorded telephone conversation on December 31, 2009, the Investment Adviser told Christanell that he needed to get HCBC above $20.00 per share and that he would be "happy" at $20.00 to $25.00 per share. At 3:55 p.m. Eastern time on December 31, 2009, Christanell routed for execution an order to buy 3,000 shares of HCBC at up to $25.00 per share. The entire order was filled at prices ranging from $16.80 to $19.50 per share. At 3:59 p.m. Eastern time, seeking a higher closing price, Christanell routed for execution a second order to buy 2,000 shares of HCBC at up to $25.00 per share. The second order was partially filled, and Christanell bought 200 shares of HCBC at $19.50 per share.

11. On December 31, 2009, HCBC closed at $19.50 per share, up $4.50 per share or 30.0% from the prior closing price on December 30. Christanell's trades on December 31 moved the market price from $16.80 per share to $19.50 per share during intraday trading. Christanell's trades on behalf of the Investment Adviser constituted 88.9% of the market volume in HCBC on December 31, 2009. Christanell's December 31, 2009 purchases for the Investment Adviser increased the market capitalization of HCBC by more than $2.4 million, from $15.0 million to $17.4 million.

12. The Investment Adviser also instructed Christanell to trade in order to artificially increase the closing price of two other securities on December 31, 2009. In a recorded telephone conversation, the Investment Adviser instructed Christanell to purchase common shares of Cheviot Financial Corp. ("CHEV"), which trades on the NASDAQ Capital Market, in order to get a closing price between $8.00 and $8.25 per share. At the time of the instruction, the Investment Adviser and Christanell knew that CHEV was trading between $7.20 and $7.48 per share. At 3:40 p.m. Eastern time, Christanell routed for execution an order to purchase 2,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $8.00 per share, with the final execution at $7.50 per share. At 3:58 p.m. Eastern time, seeking a higher closing price, Christanell routed for execution a second order to purchase 2,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $8.00 per share, with the final execution at $7.49 per share. At 3:59:20 p.m. Eastern time, still seeking a higher closing price, Christanell routed for execution a third order, this time to purchase 1,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $7.98 per share, with the last trade at $7.49 per share. At 3:59:53 p.m. Eastern time, still seeking a higher closing price, Christanell routed for execution a fourth order, this time to purchase 1,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $7.99 per share, with the last execution at $7.99 per share. On December 31, 2009, CHEV closed at $7.39 per share, down $0.07 per share or 0.9% from the closing price on December 30, 2009. Christanell's trades for the Investment Adviser were 70.7% of the market volume in CHEV on December 31, 2009. Christanell and the Investment Adviser attempted to artificially increase CHEV's closing price, but were unsuccessful.

13. The Investment Adviser also instructed Christanell to trade in order to artificially increase the closing price of Carver Bancorp, Inc. ("CARV"), which trades on the NASDAQ Capital Market, at the end of trading on December 31, 2009. In a recorded telephone conversation, the Investment Adviser told Christanell to "pop" the price of CARV "at the end of

the day." The Investment Adviser cautioned Christanell to "make sure you get a print," i.e., to ensure that the order was executed at an artificially high price and reported to the market. At 3:58 p.m. Eastern time, Christanell routed for execution an order to purchase 200 shares of CARV at up to $9.05 per share. The entire order was filled at prices up to $9.05 per share, with a final execution at $9.05 per share. CARV closed at $9.05 per share, up $0.03 or 0.3% from the prior closing price on December 30. Christanell's trades for the Investment Adviser were 100% of the market volume in CARV on December 31, 2009.

14. Section 10(b) of the Exchange Act makes it "unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" and Rule 10b-5 thereunder makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

15. As a result of the conduct described above, Christanell willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Huntleigh's Failure Reasonably to Supervise Christanell

16. Huntleigh failed to establish procedures or to have a system to implement existing policies and procedures reasonably designed to prevent and detect Christanell's marking-the-close trading. First, Huntleigh's procedures did not call for certain daily trading exception reports to be directed to compliance personnel. Second, Huntleigh's Written Supervisory Procedures directed daily review of trade tickets by Huntleigh's Compliance Director, but such daily review was suspended when Huntleigh changed clearing arrangements in 2008. Thus, once a new clearing firm was involved, Huntleigh did not revise its procedures to enable review of trade tickets. Had there been daily review of trading exception reports and, as directed by Huntleigh's Written Supervisory Procedures, of trade tickets, Christanell's violative trading could have been prevented and detected.

17. Section 15(b)(4)(E) of the Exchange Act requires broker-dealers reasonably to supervise persons subject to their supervision, with a view toward preventing violations of the federal securities laws. See, e.g., Dean Witter Reynolds, Inc., Exchange Act Rel. No. 46578 (Oct. 1, 2002). The Commission has emphasized that the "responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." Id.

18. As a result of the conduct described above, Huntleigh failed reasonably to supervise Christanell, with a view to detecting and preventing Christanell's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, within the meaning of Section 15(b)(4)(E) of the Exchange Act.

Civil Penalties

19. Respondent Huntleigh Securities Corporation has submitted a sworn Statement of Financial Condition as of November 30, 2010 dated January 7, 2011 and other evidence and has asserted its inability to pay a civil penalty.

IV.

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

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

A. Respondent Jeffrey S. Christanell cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

B. Respondent Jeffrey S. Christanell be, and hereby is (i) barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, (ii) barred from participating in an offering of penny stock, and (iii) prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, with the right to reapply for association after one (1) year to the appropriate self-regulatory organization, or, if there is none, to the Commission;

Any reapplication for association by Respondent Jeffrey S. Christanell 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 Respondent Christanell, 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;

C. Respondent Jeffrey S. Christanell shall pay a civil money penalty in the amount of $15,000 to the United States Treasury. Payments shall be made in the following installments: (1) a first payment of $5,000 within thirty (30) days of entry of this Order, (2) a second payment of $5,000 within ninety (90) days of the first payment, and (3) a third payment of $5,000 within ninety (90) days of the second payment. If timely payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application. 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 Jeffrey S. Christanell 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 Julie M. Riewe, Assistant Director, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-5010;

D. Respondent Huntleigh Securities Corporation be, and hereby is, censured;

E. Respondent Huntleigh Securities Corporation shall comply with the following undertakings:

1. Huntleigh Securities Corporation will take steps to effect compliance with Section 15(b)(4)(E) of the Exchange Act by reviewing and revising, as necessary, currently adopted and implemented procedures concerning manipulative trading and, including at a minimum, by adopting and implementing procedures requiring daily review of trade execution blotters by compliance personnel and provision to and review of daily trading exception reports by compliance personnel. Within 60 days from the entry of this Order, Respondent Huntleigh Securities Corporation shall submit an affidavit to the Commission staff attesting to their compliance with these undertakings.

2. Huntleigh will certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent Huntleigh Securities Corporation agrees to provide such evidence. The certification and supporting material shall be submitted to Julie M. Riewe, Assistant Director, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

F. Based upon Respondent Huntleigh Securities Corporation's sworn representations in its Statement of Financial Condition as of November 30, 2010 dated January 7, 2011 and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent Huntleigh Securities Corporation; and

G. 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 Huntleigh Securities Corporation 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 Huntleigh

Securities Corporation was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent Huntleigh Securities Corporation may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64337 / April 25, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3190 / April 25, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29659 / April 25, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14355

In the Matter of **DONALD L. KOCH and KOCH ASSET MANAGEMENT LLC,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AND NOTICE OF HEARING**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Company Act") against Donald L. Koch and Koch Asset Management LLC (collectively, "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

Respondents

1. Respondent Donald L. Koch ("Koch"), age 64, resides in St. Louis, Missouri. Koch is the President, Chief Compliance Officer, and founder of SEC-registered investment adviser Koch Asset Management LLC in St. Louis, Missouri.

2. Respondent Koch Asset Management LLC ("KAM") is a Missouri limited liability company and investment adviser that has been registered with the Commission since 1992. It provides investment advisory services to approximately 40 discretionary advisory accounts containing approximately $40 million in assets.

Other Entities

3. Huntleigh Securities Corporation, a Missouri corporation with its primary place of business in St. Louis, Missouri, is a broker-dealer registered with the Commission and FINRA since 1977.

Factual Background

A. Marking-the-Close Transactions

4. From September 2009 through December 2009, KAM and Koch engaged in a scheme to mark-the-close of certain thinly traded securities held in KAM's clients' investment accounts.

5. KAM, through Koch, instructed a trader at Huntleigh Securities Corporation ("Trader A") to execute trades in order to inflate the prices of certain thinly-traded securities held by KAM's advisory clients by placing buy orders at prices well above the most recent previous trade shortly before the markets closed. This trading strategy, known as "marking the close," involves the placing of orders at or near the close of market trading to artificially affect the reported closing price of a security.

6. Koch instructed Trader A to execute marking-the-close transactions to improve the portfolio performance reported to KAM's advisory clients on their monthly account statements. KAM manages separate accounts for approximately 40 advisory clients. Koch employs the same investment strategy in all KAM accounts, which hold many similar securities. Monthly portfolio performance was reported based on the change in the value of portfolio securities as of the last trading day of each month. KAM, by marking-the-close in a security held by many of its advisory accounts, was able to artificially improve the reported monthly performance for each account holding that security.

7. On September 30, 2009, Koch instructed Trader A to buy shares of the common stock of issuer High Country Bancorp, Inc. ("HCBC"), which are quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group, Inc. ("OTC Link"), to artificially increase the closing price. In an email, Koch told Trader A to buy HCBC shares just before the market close at a price "as near to $25 [per share] as possible without appearing manipulative." At 3:56 p.m. Eastern time, Trader A routed for execution an order to purchase 2,000 shares of HCBC at up to $24.50 per share. The order was partially filled as Trader A bought 1,400 HCBC shares for KAM at prices up to $23.99 per share.

8. KAM's purchases were the only trading in HCBC on September 30. HCBC closed at $23.50 per share, up $5.50 per share or 30.5% from the closing price on September 29. KAM's September 30, 2009 purchases of HCBC for its advisory accounts increased the market capitalization of HCBC by more than $4.9 million, from $16.1 million to $21.0 million.

9. Many of KAM's clients' separately managed accounts held HCBC shares, but Koch allocated all the HCBC shares solely to the account of one client, a 92-year old retired homemaker. The allocated shares increased the account's holdings of HCBC by approximately 35%. The shares allocated to this account had a weighted average cost of $20.38 per share, up more than 13% from the previous closing price. Koch's instruction to mark-the-close in HCBC on September 30, 2009 caused this account to overpay for shares of HCBC.

10. Trader A testified that on October 30, 2009, Koch again instructed Trader A to buy HCBC shares to artificially increase the closing price. At 3:46 p.m. Eastern time, Trader A routed for execution a market order to buy 600 shares of HCBC. The order was completely filled at prices up to $19.75 per share.

11. KAM's October 30, 2009 trades rapidly moved HCBC's price from $14.00 per share to its close at $19.75 per share, up $6.49 per share or 48.9% from the prior closing price on October 29. KAM's trades constituted 42.9% of the market volume in HCBC on October 30, 2009. KAM's October 30, 2009 purchases for its advisory accounts increased the market capitalization of HCBC by more than $5.8 million, from $11.8 million to $17.6 million.

12. On October 30, 2009, Koch again allocated the HCBC shares only to KAM's 92-year old retired homemaker client. The allocated shares increased the account's holdings of HCBC by another 10%. The shares obtained on October 30, 2009 had a weighted average cost of $17.25 per share, up more than 23% from the previous closing price. Koch's instruction to mark-the-close in HCBC on October 30, 2009 again caused this account to overpay for shares of HCBC.

13. Trader A testified that on November 30, 2009, Koch again instructed Trader A to buy HCBC shares to artificially increase the closing price. At 3:57 p.m. Eastern time, Trader A routed for execution an order to buy 1,000 shares of HCBC at up to $21.00 per share. The entire order was filled at $17.00 per share. At 3:58 p.m. Eastern time, seeking, per Koch's instruction, to get a higher closing price, Trader A routed for execution a second order to buy 1,000 shares of HCBC at up to $21.00 per share. The second order was entirely filled at $17.49 per share.

14. On November 30, 2009, HCBC closed at $17.49 per share, up $2.49 per share or 16.6% from the prior closing price on November 27 (the previous trading day). KAM's trading was 100% of the market volume in HCBC on November 30, 2009 and moved the market price from $15.00 per share to $17.49 per share. KAM's purchases for its advisory accounts increased the market capitalization of HCBC by more than $2.2 million, from $13.4 million to $15.6 million.

15. On November 30, 2009, Koch allocated the HCBC shares KAM purchased to an account beneficially owned by the same 92-year old retired homemaker client. The shares

obtained on November 30, 2009 had a weighted average cost of $17.25 per share, up 15% from the previous closing price.

16. On December 31, 2009, Koch again instructed Trader A to buy HCBC shares to artificially increase the closing price. In a December 23, 2009 email, Koch informed Trader A that he "want[ed] to move up HCBC the last day of the year." In a December 28, 2009 email, Koch told Trader A to "[p]lease put on your calendar to buy HCBC 30 minutes to an hour before the close of market for the year. I would like to get a closing price in the 20-25 range, but certainly above 20." In a recorded telephone conversation on December 31, 2009, Koch told Trader A that he needed to get HCBC above $20.00 per share and that he would be "happy" at $20.00 to $25.00 per share. At 3:55 p.m. Eastern time on December 31, 2009, Trader A routed for execution an order to buy 3,000 shares of HCBC at up to $25.00 per share. The entire order was filled at prices ranging from $16.80 to $19.50 per share. At 3:59 p.m. Eastern time, seeking, per Koch's instructions, a higher closing price, Trader A routed for execution a second order to buy 2,000 shares of HCBC at up to $25.00 per share. The second order was partially filled, and Trader A bought KAM 200 shares of HCBC at $19.50 per share.

17. On December 31, 2009, HCBC closed at $19.50 per share, up $4.50 per share or 30.0% from the prior closing price on December 30. KAM's trades on December 31 moved the market price from $16.80 per share to $19.50 per share during intraday trading. KAM's trades constituted 88.9% of the market volume in HCBC on December 31, 2009. KAM's December 31, 2009 purchases for its advisory accounts increased the market capitalization of HCBC by more than $2.4 million, from $15.0 million to $17.4 million.

18. Koch also instructed Trader A to trade in order to artificially increase the closing price of two other securities on December 31, 2009. In a recorded telephone conversation, Koch instructed Trader A to purchase common shares of Cheviot Financial Corp. ("CHEV"), which trades on the NASDAQ stock exchange, in order to get a closing price between $8.00 and $8.25 per share. At the time of the instruction, Koch knew that CHEV was trading between $7.20 and $7.48 per share. At 3:40 p.m. Eastern time, per Koch's instruction, Trader A routed for execution an order to purchase 2,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $8.00 per share, with the final execution at $7.50 per share. At 3:58 p.m. Eastern time, seeking a higher closing price per Koch's instruction, Trader A routed for execution a second order to purchase 2,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $8.00 per share, with the final execution at $7.49 per share. At 3:59:20 p.m. Eastern time, still seeking a higher closing price, Trader A routed for execution a third order, this time to purchase 1,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $7.98 per share, with the last trade at $7.49 per share. At 3:59:53 p.m. Eastern time, still seeking a higher closing price, Trader A routed for execution a fourth order, this time to purchase 1,000 shares of CHEV at up to $8.25 per share. The entire order was filled at prices up to $7.99 per share, with the last execution at $7.99 per share. On December 31, 2009, CHEV closed at $7.39 per share, down $0.07 per share or 0.9% from the closing price on December 30. KAM's trades constituted 70.7% of the market volume in CHEV on December 31, 2009. In the case of CHEV, KAM and Koch attempted to manipulate the closing price, but the trades were ultimately unsuccessful in increasing CHEV's closing price.

19. On December 31, 2009, Koch also instructed Trader A to trade in order to artificially increase the closing price of Carver Bancorp., Inc. ("CARV"), which trades on the NASDAQ stock exchange. In a recorded telephone conversation, Koch told Trader A to "pop" the price of CARV "at the end of the day." Koch cautioned Trader A to "make sure you get a print," i.e., to ensure that the order was executed at an artificially high price and was reported to the market. At 3:58 p.m. Eastern time, per Koch's instruction, Trader A routed for execution an order to purchase 200 shares of CARV at up to $9.05 per share. The entire order was filled at prices up to $9.05 per share, with a final execution at $9.05 per share. CARV closed at $9.05 per share, up $0.03 or 0.3% from the prior closing price on December 30. KAM's trades constituted 100% of the market volume in CARV on December 31, 2009.

20. All the HCBC, CHEV, and CARV shares KAM purchased on December 31, 2009 were allocated to a single KAM advisory client account.

B. Failure to Seek Best Execution

21. KAM and Koch, by placing orders to purchase securities for their advisory clients at artificially inflated prices, breached their fiduciary duty to seek best execution for their clients.

C. Failure to Maintain Required Books & Records

22. KAM did not maintain communications related to the placing and execution of orders to purchase securities, including electronic communications related to such orders. In particular, Koch caused KAM to delete electronic communications related to the placing and execution of orders to purchase shares of HCBC in December 2009.

23. Koch, as KAM's President and Chief Compliance Officer, had responsibility for KAM's maintenance of required books and records.

D. Failure to Implement Policies and Procedures to Prevent Violation of the Advisers Act

24. KAM failed to implement policies and procedures reasonably designed to prevent violations of the Advisers Act. KAM's Policies and Procedures Manual explicitly prohibits "transactions intended to raise, lower, or maintain the price of any [s]ecurity…." KAM, however, implemented no procedures designed to prevent or detect such transactions, relying entirely on the integrity of Koch, its principal, not to engage in prohibited transactions.

25. Koch, as KAM's President and Chief Compliance Officer, had responsibility for KAM's policies and procedures.

Violations

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

27. As a result of the conduct described above, KAM and Koch willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser.[1]

28. As a result of the conduct described above, KAM willfully violated, and Koch willfully aided and abetted and caused violations of, Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires investment advisers to implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules that the Commission has adopted thereunder.

29. As a result of the conduct described above, KAM willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder, which require the maintenance of certain books and records. Koch willfully aided and abetted and caused KAM's violations of Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder.

III.

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

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

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

C. What, if any, remedial action is appropriate in the public interest against Respondent Koch pursuant to Section 9(b) of the Investment Company Act;

D. Whether, pursuant to Section 21C of the Exchange Act and Section 203(k) of the Advisers Act, Respondent KAM should be ordered to cease and desist from committing or causing violations of and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 204, 206(1), 206(2), and 206(4) of the Advisers Act and Rules 204-2(a)(7) and 206(4)-7 thereunder;

E. Whether, pursuant to Section 21C of the Exchange Act and Section 203(k) of the Advisers Act, Respondent Koch should be ordered to cease and desist from committing or

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1 KAM, a registered investment adviser, and Koch, who controls KAM and acts as an investment adviser, directly violated Sections 206(1) and 206(2) of the Advisers Act. KAM's advisory accounts paid an asset management fee to KAM. Koch may be charged directly under Section 206 because his activities and complete control and ownership of KAM satisfy the broad definition of "investment adviser." See In the Matter of John J. Kenny and Nicholson/Kenny Capital Management, Inc., Advisers Act Release No. 2128 (May 14, 2003) (associated person who was the adviser's chairman and chief executive and, with his wife, owner of the adviser's holding company primarily liable).

causing violations of and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1) and 206(2) of the Advisers Act, and from aiding and abetting or causing any violations of Sections 204 and 206(4) of the Advisers Act and Rules 204-2(a)(7) and 206(4)-7 thereunder.

IV.

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

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 210.220.

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64339 / April 26, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14356

In the Matter of Commercial Mortgage Resources Corp., Compressant Corp., Compression Labs, Inc., Consolidated Golden Quail Resources, Ltd., Consolidated NRD Resources Ltd., Contemporary Solutions, Inc. (n/k/a Purescience), Continental Heritage Corp. (n/k/a Visionquest Worldwide Holdings Corp.), and Corniche Corp., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Commercial Mortgage Resources Corp., Compressant Corp., Compression Labs, Inc., Consolidated Golden Quail Resources Ltd., Consolidated NRD Resources Ltd., Contemporary Solutions, Inc. (n/k/a Purescience), Continental Heritage Corp. (n/k/a Visionquest Worldwide Holdings Corp.), and Corniche Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Commercial Mortgage Resources Corp. (CIK No. 878235) is a void Delaware corporation located in Scottsdale, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Commercial Mortgage Resources is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 1997, which reported a net loss of $250 for the prior three months.

2. Compressant Corp. (CIK No. 1013273) is a Florida corporation located in San Jose, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Compressant 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, 1998, which reported a net loss of $6.4 million for the prior nine months.

3. Compression Labs, Inc. (CIK No. 319085) is a Delaware corporation located in San Jose, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Compression Labs is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1997, which reported a net loss of over $4.2 million for the prior three months.

4. Consolidated Golden Quail Resources Ltd. (CIK No. 802700) is a British Columbia corporation located in Carlsbad, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Consolidated Golden Quail 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, 1998, which reported a net loss of over $221,000 for the prior nine months.

5. Consolidated NRD Resources Ltd. (CIK No. 769508) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Consolidated NRD Resources is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 1996, which reported a net loss of over $28,000 for the three month-period ended March 31, 1997.

6. Contemporary Solutions, Inc. (n/k/a Purescience) (CIK No. 1101357) is a dissolved Wyoming corporation located in Springville, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Contemporary Solutions is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2006, which reported a net loss of over $211,000 for the prior nine months. On November 25, 1996, Contemporary Solutions filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Western District of Louisiana, which was terminated on April 30, 1997.

7. Continental Heritage Corp. (n/k/a Visionquest Worldwide Holdings Corp.) (CIK No. 24055) is a void Delaware corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Continental Heritage 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, 2000, which reported a net loss of over $759,000 for the prior six months.

8. Corniche Corp. (CIK No. 1140007) is a permanently revoked Nevada corporation located in Newport Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Corniche 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 $6,600 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 domestic issuers to file quarterly reports. Rule 13a-16 requires foreign private issuers to furnish quarterly and other reports to the Commission under cover of Form 6-K if they make or are required to make the information public under the laws of the jurisdiction of their domicile or in which they are incorporated or organized; if they file or are required to file information with a stock exchange on which their securities are traded and the information was made public by the exchange; or if they distribute or are required to distribute information to their security holders.

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

III.

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

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

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

IV.

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

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

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64340 / April 26, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14357

In the Matter of **Safe Waste Systems, Inc.,** **Salex Holding Corp.,** **San Fabian Resources, Inc.,** **Sanitas, Inc.,** **Select Therapeutics, Inc. (f/k/a VT Development, Inc.),** **Sel-Leb Marketing, Inc.,** **Semicon, Inc.,** **Serino 2, Corp.,** **Serino 3, Corp.,** **Serino 4, Corp.,** **Serino 5, Corp., and** **Serino 6, Corp.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Safe Waste Systems, Inc., Salex Holding Corp., San Fabian Resources, Inc., Sanitas, Inc., Select Therapeutics, Inc. (f/k/a VT Development, Inc.), Sel-Leb Marketing, Inc., Semicon, Inc., Serino 2, Corp., Serino 3, Corp., Serino 4, Corp., Serino 5, Corp., and Serino 6, Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Safe Waste Systems, Inc. (CIK No. 769107) is a void Delaware corporation located in Wanamassa, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Safe Waste Systems 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, 1993, which reported a net loss of over $473,000 for the prior nine months.

2. Salex Holding Corp. (CIK No. 918963) is a void Delaware corporation located in Happauge, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Salex 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 January 31, 2000, which reported a net loss of over $1.1 million for the prior twelve months. On November 17, 2000, Salex filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Eastern District of New York, which was converted to Chapter 7, and the case was terminated on March 31, 2004.

3. San Fabian Resources, Inc. (CIK No. 1091562) is a void Delaware corporation located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). San Fabian is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed an amended Form 10-SB registration statement on December 9, 1999, which reported a net loss of over $21,000 between its May 19, 1997 inception date and April 30, 1999.

4. Sanitas, Inc. (CIK No. 86727) is a Connecticut corporation located in Stamford, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sanitas 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, 1996, which reported a net loss of $38,000 for the prior nine months.

5. Select Therapeutics, Inc. (f/k/a VT Development, Inc.) (CIK No. 1037158) is a void Delaware corporation located in Brookline, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Select Therapeutics 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 over $4.5 million for the prior nine months.

6. Sel-Leb Marketing, Inc. (CIK No. 934853) is an inactive New York corporation located in Paterson, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sel-Leb Marketing 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 over $171,000 for the prior three months.

7. Semicon, Inc. (CIK No. 88922) is a dissolved Massachusetts corporation located in Burlington, Massachusetts with a class of securities registered with the

Commission pursuant to Exchange Act Section 12(g). Semicon 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 4, 1998, which reported a net loss of $254,000 for the prior three months.

8. Serino 2, Corp. (CIK No. 1331613) is a New Jersey corporation located in Jersey City, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Serino 2 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 January 31, 2006, which reported a net loss of $1,050 for the prior nine months.

9. Serino 3, Corp. (CIK No. 1331615) is a New Jersey corporation located in Jersey City, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Serino 3 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 January 31, 2006, which reported a net loss of $1,050 for the prior nine months.

10. Serino 4, Corp. (CIK No. 1331616) is a New Jersey corporation located in Jersey City, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Serino 4 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the fiscal year ended April 30, 2006, which reported a net loss of $1,650 for the prior fiscal year.

11. Serino 5, Corp. (CIK No. 1331617) is a New Jersey corporation located in Jersey City, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Serino 5 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the fiscal year ended April 30, 2006, which reported a net loss of $1,650 for the prior fiscal year.

12. Serino 6, Corp. (CIK No. 1331618) is a New Jersey corporation located in Jersey City, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Serino 6 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the fiscal year ended April 30, 2006, which reported a net loss of $1,650 for the prior fiscal year.

B. DELINQUENT PERIODIC FILINGS

13. 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.

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

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

III.

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

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

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

IV.

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

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

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64344 / April 26, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14358

In the Matter of

JOSHUA F. ESCOBEDO,

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 Joshua F. Escobedo ("Respondent" or "Escobedo").

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. From approximately September 2003 through October 2009, Respondent worked for various entities controlled by Michael P. Watson, including Mike Watson Capital, LLC ("MWC"), and sold investments in MWC. Respondent does not hold any securities licenses and he acted as an unregistered broker in connection with his offer and sale of securities. Specifically, Respondent made use of the mails or means or instrumentalities of interstate commerce to effect transactions in or to induce or attempt to induce the purchase or sale of a security without being registered in accordance with Section 15(b) of the Exchange Act.

2. On April 7, 2011, a final judgment was entered by consent against Escobedo, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, 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. Mike Watson Capital, LLC, et al., Civil Action Number 2:22-cv-00275-DB in the United States District Court for the District of Utah.

3. The Commission's complaint alleged that, from at least October 2004 through at least February 2009, Defendants, including Escobedo, sold the securities of MWC by making materially false representations to investors regarding, among other things, the intended use of the proceeds from the sale of such securities, and the real estate holdings, equity, and positive cash flow from operations of MWC. The complaint also alleged that Defendants omitted the material fact that the proceeds from the sale of these securities were used, in Ponzi-like fashion, to make principal and interest payments to other investors in these securities. The complaint further alleged that Escobedo acted as an unregistered broker and sold unregistered securities.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Escobedo be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

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 Parts 240, 242, and 249

Release No. 34-64352; File No. S7-15-11

RIN 3235-AL14

REMOVAL OF CERTAIN REFERENCES TO CREDIT RATINGS UNDER THE SECURITIES EXCHANGE ACT OF 1934

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of several proposed rules that the Securities and Exchange Commission (the "Commission") will be considering relating to the use of credit ratings in Commission rules and forms. Section 939A of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires the Commission to remove any references to credit ratings from its regulations and to substitute such standard of creditworthiness as the Commission determines to be appropriate. In this release, the Commission is proposing to amend certain rules and one form under the Securities Exchange Act of 1934 (the "Exchange Act") applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions. The Commission also is requesting comment on potential standards of creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), which define the terms "mortgage related security" and "small business related security," respectively, as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

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

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-15-11 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 S7-15-11. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's internet website (http://www.sec.gov/rules/concept.shtml). Comments are also available for website 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 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551-5521; Randall W. Roy, Assistant Director, at (202) 551-5522; Mark M. Attar, Branch Chief, at (202) 551-5889; Carrie A. O'Brien, Special Counsel, at (202) 551-5640; and Leigh E. Bothe, Attorney, at (202) 551-5511, Office of Financial Responsibility (Net Capital, Customer Protection, and Books and Records Requirements, and Section 939(e) of the Dodd-Frank Act); Josephine J. Tao, Assistant Director, Elizabeth A. Sandoe, Senior Special Counsel, David P. Bloom, Branch Chief, or Bradley Gude, Special Counsel, Office of Trading Practices and Processing at (202) 551-5720 (Regulation M); and Joseph M. Furey, Co-Acting Chief Counsel, and Ignacio Sandoval, Special Counsel, Office of Chief Counsel at (202) 551-5550 (Confirmation of Transactions), Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: On July 21, 2010, the President signed the Dodd-Frank Act into law. The Commission is requesting public comment on proposed amendments to Exchange Act Rules 15c3-1, 15c3-3, 17a-4, 101 and 102 of Regulation M, and 10b-10, and one Exchange Act form – Form X-17A-5, Part IIB – to remove references to credit ratings and, in certain cases, substitute alternative standards of creditworthiness as required by Section 939A of the Dodd-Frank Act.[1] The Commission is also requesting public comment on potential standards of creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), which define the terms "mortgage related security" and "small business related security," respectively, as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

I. BACKGROUND

A. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

The Dodd-Frank Act was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.[2] Title

[1] See Pub. L. No. 111-203 § 939A.
[2] See Pub. L. No. 111-203, 124 Stat. 1376 (2010); Pub. L. No. 111-203, Preamble.

IX, Subtitle C, of the Dodd-Frank Act[3] includes provisions regarding statutory and regulatory references to credit ratings in Exchange Act rules, as well as in the Exchange Act itself.[4]

Specifically, in Section 939A of the Dodd-Frank Act, Congress requires that the Commission "review any regulation issued by [the Commission] that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings."[5] Once the Commission has completed that review, the statute provides that the Commission "remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of credit-worthiness" as the Commission determines to be appropriate.[6]

As is discussed in detail below, there are five Exchange Act rules – Rule 15c3-1, Rule 15c3-3, Rules 101 and 102 of Regulation M, and Rule 10b-10 – administered by the Commission and one Exchange Act form – Form X-17A-5, Part IIB – that the Commission is proposing to amend in this release as directed by Section 939A of the Dodd-Frank Act. The Commission is also proposing corresponding changes to Exchange Act Rule 17a-4, relating to broker-dealer recordkeeping.

Further, in Section 939(e) of the Dodd-Frank Act,[7] Congress deleted Exchange Act references to credit ratings in two sections: (1) in Exchange Act Section 3(a)(41),[8] which defines

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3 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

4 These provisions are designed "[t]o reduce the reliance on ratings." See Joint Explanatory Statement of the Committee of Conference, Conference Committee Report No. 111-517, to accompany H.R. 4173, 864-879, 870 (Jun. 29, 2010).

5 Pub. L. No. 111-203 § 939A(a)(1)-(2).

6 See Pub. L. No. 111-203 § 939A(b). The Commission has recently proposed amendments to its rules in other contexts under the federal securities laws to remove references to credit ratings. See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Securities Act of 1933 ("Securities Act") Release No. 9193 (Mar. 3, 2011), 76 FR 12896 (Mar. 9, 2011) and Security Ratings, Exchange Act Release No. 63874 (Feb. 9, 2011), 76 FR 8946 (Feb. 16, 2011).

7 Pub. L. No. 111-203 § 939(e).

8 15 U.S.C. 78c(a)(41).

the term "mortgage related security," and (2) in Exchange Act Section 3(a)(53),[9] which defines the term "small business related security." In place of the credit rating references, Congress added language stating that a mortgage related security and a small business related security will need to satisfy "standards of credit-worthiness as established by the Commission."[10] This replacement language becomes effective on July 21, 2012 (i.e., two years after the date the Dodd-Frank Act was signed into law).

As is discussed in detail below, the Commission also is requesting comment on potential standards of creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

B. PREVIOUS COMMISSION ACTION

In 1975, the Commission adopted the term "nationally recognized statistical rating organization" ("NRSRO") as part of the Commission's amendments to its broker-dealer net capital rule, Exchange Act Rule 15c3-1 (the "Net Capital Rule").[11] Although the Commission originated the use of the term NRSRO for a narrow purpose in its own regulations, ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules by financial and other regulators, foreign regulatory schemes, and private financial contracts. The Commission's initial regulatory use of the term NRSRO was intended solely to provide a method for determining capital charges on different grades of debt securities under the Net Capital Rule. The Commission's reference to NRSROs for purposes of certain rules increased over time.

Subsequent to the adoption of many of the Commission's requirements using the NRSRO concept, the Commission – in 2006 – obtained registration and oversight authority with respect

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9 15 U.S.C. 78c(a)(53).

10 Pub. L. No. 111-203 § 939(e).

11 See Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (Jun. 26, 1975), 40 FR 29795 (Jul. 16, 1975) and 17 CFR 240.15c3-1.

to credit rating agencies that register to be treated as NRSROs.[12] In response, the Commission adopted rules to implement a registration and oversight program for NRSROs in June 2007.[13]

The Commission notes that this is not the first time that the Commission has proposed to remove references to credit ratings in Commission rules. The Commission issued a concept release in 1994 on the general idea of removing references to NRSROs in its rules.[14] In 2003, the Commission again sought comment on whether it should eliminate the NRSRO designation from Commission rules, and, if so, what alternatives could be adopted to meet the Commission's regulatory objectives.[15] Most recently, in July 2008, the Commission made specific proposals to remove rule references to ratings by NRSROs.[16] In response, the Commission received many

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12 See Credit Rating Agency Reform Act of 2006 ("Rating Agency Act of 2006"); Pub. L. No. 109-291 (2006). Among other things, the Rating Agency Act of 2006 defined the terms "credit rating agency" and "nationally recognized statistical rating organization" in Exchange Act Sections 3(a)(61) and 3(a)(62), respectively. See Pub. L. No. 109-291 § 3. Under Section 3(a)(61), the term "credit rating agency" means any person: (A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (C) receiving fees from either issuers, investors, or other market participants, or a combination thereof. 15 U.S.C. 78c(a)(61). Under Section 3(a)(62), the term "nationally recognized statistical rating organization" means a credit rating agency that: (A) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix) of the Exchange Act, with respect to (i) financial institutions, brokers, or dealers; (ii) insurance companies; (iii) corporate issuers; (iv) issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations, as in effect on the date of enactment of this paragraph); (v) issuers of government securities, municipal securities, or securities issued by a foreign government; or (vi) a combination of one or more categories of obligors described in any clauses (i) through (v); and (B) is registered under Exchange Act Section 15E.

13 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (Jun. 5, 2007), 72 FR 33564 (Jun. 18, 2007). The implementing rules were Form NRSRO, Rule 17g-1, Rule 17g-2, Rule 17g-3, Rule 17g-4, Rule 17g-5, and Rule 17g-6. The Commission has twice adopted amendments to some of these rules. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59342 (Feb. 2, 2009), 74 FR 6456 (Feb. 9, 2009); and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009). The Commission also recently added a new NRSRO rule. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act Release No. 9175 (Jan. 20, 2011), 76 FR 4489 (Jan. 26, 2011).

14 See Concept Release: Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34616 (Aug. 31, 1994), 59 FR 46314 (Sep. 7, 1994).

15 See Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Exchange Act Release No. 47972 (Jun. 4, 2003), 68 FR 35258 (Jun. 12, 2003).

16 See Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008).

comments that raised serious concerns about removing the references.[17] Commenters argued that removing NRSRO references in the context of the Net Capital Rule would decrease the transparency of broker-dealers' net capital computations and negatively affect market confidence in the financial strength of broker-dealers.[18] In addition, commenters contended that the proposed amendments would place an undue burden on broker-dealers to justify the propriety of internal methods for determining haircuts and on Commission examiners who might be required to review those methods.[19]

In October 2009, the Commission adopted several of the proposed reference removals and re-opened for comment the remaining proposals.[20] As noted above, in each of these concept releases and rule proposals, commenters generally did not support the removal of references to NRSRO ratings from Commission rules and provided few possible regulatory alternatives. The Commission recognizes the concerns raised by commenters that replacing credit ratings – which provide an objective benchmark – with more subjective approaches could increase costs to broker-dealers and the Commission. For example, broker-dealers would be required to allocate resources toward developing and maintaining compliance processes, and the Commission would

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17 See Comments on References to Ratings of NRSROs, available on the Commission's internet website at http://www.sec.gov/comments/s7-17-08/s71708.shtml.

18 See, e.g., Letter from Jeffrey T. Brown, Senior Vice President, Charles Schwab & Co., Inc. to Florence E. Harmon, Acting Secretary, Commission, dated Sep. 5, 2008, stating, "we are concerned that the Commission's proposed amendments to remove references to NRSRO ratings from [R]ule 15c3-1 (the Net Capital Rule) … may be destabilizing and inject risk and uncertainty into the operations of broker-dealers, investment advisers and money market mutual funds. We urge the Commission to retain the references to NRSRO ratings as a minimum floor of credit quality."

19 See, e.g., Deborah A. Cunningham and Boyce I. Greer, SIFMA Credit Rating Agency Task Force Co-Chair to Elizabeth M. Murphy, Secretary, Commission, dated Dec. 9, 2009.

20 See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60789 (Oct. 5, 2009), 74 FR 52358 (Oct. 9, 2009) (adopting release). In the adopting release, the Commission amended Exchange Act Rule 3a1-1 (17 CFR 240.3a1-1), Exchange Act Rules 300, 301(b)(5) and 301(b)(6) of Regulation ATS (17 CFR 242.300, 242.301(b)(5) and 242.301(b)(6)), Form ATS-R (17 CFR 249.638) and Form PILOT (17 CFR 249.821). The Commission also adopted amendments to Rules 5b-3 and 10f-3 under the Investment Company Act of 1940 (17 CFR 270.5b-3 and 17 CFR 270.10f-3). See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60790 (Oct. 5, 2009), 74 FR 52374 (Oct. 9, 2009) (re-opening comment for Net Capital Rule purposes and various Exchange Act rules).

likewise be required to allocate resources toward examining for compliance. The Commission also recognizes that an alternative approach, if too rigid, could narrow the types of financial instruments that qualify for benefits under existing rules and, if too flexible, could broaden the types of financial instruments that qualify for benefits under existing rules. The Commission, in proposing alternatives to credit ratings, is seeking generally to neither narrow nor broaden the scope of financial instruments that would qualify for the benefits conferred in the existing rules while, at the same time, fulfilling the statutory mandate in Section 939A of the Dodd-Frank Act.[21] In this regard, the Commission seeks comment below on whether the proposed alternatives achieve this goal and whether more effective alternatives exist.

II. COMMISSION PROPOSALS

A. PROPOSED AMENDMENTS TO EXCHANGE ACT RULE 15c3-1 AND THE APPENDICES TO THE RULE

1. Amendments to Rule 15c3-1

As noted above, the Commission first developed the NRSRO concept for use in the Net Capital Rule. The Net Capital Rule prescribes minimum regulatory capital requirements for broker-dealers.[22] A "net liquid assets test" is the fundamental requirement of the Net Capital Rule. This test is designed to provide that a registered broker-dealer maintain at all times more than one dollar of highly liquid assets for each dollar of liabilities (e.g., money owed to customers and counterparties), excluding liabilities that are subordinated to all other creditors by contractual agreement. Consequently, if the broker-dealer experiences financial difficulty, it should be in a position to meet all obligations to customers and counterparties and generate resources to wind-down its operations in an orderly manner without the need of a formal proceeding. The Net Capital Rule operates by requiring a broker-dealer to perform two

[21] See Pub. L. No. 111-203 § 939.
[22] See 17 CFR 240.15c3-1(a).

calculations: (1) a computation of required minimum net capital; and (2) a computation of actual net capital. A broker-dealer must ensure that its actual net capital exceeds its minimum net capital requirement at all times.

To calculate its actual net capital, a broker-dealer first computes its net worth in accordance with generally accepted accounting principles and then adds to this amount certain subordinated liabilities. From that figure, the broker-dealer subtracts assets not readily convertible into cash, such as intangible assets, fixed assets, and most unsecured receivables. The broker-dealer then subtracts prescribed percentages of the market value of securities owned by the broker-dealer (otherwise known as "haircuts") to discount for potential market movements. A primary purpose of these haircuts is to provide a margin of safety against losses that might be incurred by the broker-dealer as a result of market fluctuations in the prices of, or lack of liquidity in, its proprietary positions. The resulting figure is the broker-dealer's net capital.

The Net Capital Rule currently applies a lower haircut to certain types of securities held by a broker-dealer if the securities are rated in higher rating categories by at least two NRSROs, since those securities typically are more liquid and less volatile in price than securities that are rated in the lower categories or are unrated. Currently, to receive the benefit of a reduced haircut on commercial paper, the commercial paper must be rated in one of the three highest rating categories by at least two NRSROs.[23] To receive the benefit of a reduced haircut on a nonconvertible debt security and preferred stock, the security must be rated in one of the four highest rating categories by at least two NRSROs.[24]

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23 17 CFR 240.15c3-1(c)(2)(vi)(E).

24 17 CFR 240.15c3-1(c)(2)(vi)(F)(1) and (c)(2)(vi)(H).

In conformance with the Dodd-Frank Act, the Commission is proposing to remove from the Net Capital Rule all references to credit ratings and substitute an alternative standard of creditworthiness. Specifically, in place of the current Net Capital Rule references to credit ratings, the Commission is proposing that a broker-dealer take a 15% haircut on its proprietary positions in commercial paper, nonconvertible debt, and preferred stock unless the broker-dealer has a process for determining creditworthiness that satisfies the criteria described below. However, commercial paper, nonconvertible debt, and preferred stock without a ready market would remain subject to a 100% haircut.[25] The 15% haircut is derived from the catchall haircut amount that applies to a security not specifically identified in the Net Capital Rule as having an asset-class specific haircut, provided the security is otherwise deemed to have a ready market.[26] It is also the haircut applicable to most equity securities.[27]

If a broker-dealer establishes, maintains, and enforces written policies and procedures for determining creditworthiness under the proposed amendments, the broker-dealer would be permitted to apply the lesser haircut requirement currently specified in the Net Capital Rule for commercial paper (i.e., between zero and ½ of 1%), nonconvertible debt (i.e., between 2% and 9%), and preferred stock (i.e., 10%) when the creditworthiness standard is satisfied. Under this proposal, in order to use these lower haircut percentages for commercial paper, nonconvertible debt, and preferred stock, a broker-dealer would be required to establish, maintain, and enforce written policies and procedures designed to assess the credit and liquidity risks applicable to a

25 The term "ready market" is defined in the Net Capital Rule as "a market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom." 17 CFR 240.15c3-1(c)(11).

26 17 CFR 240.15c3-1(c)(2)(vi)(J). Securities without a ready market would remain subject to a 100% haircut. 17 CFR 240.15c3-1(c)(2)(vii).

27 17 CFR 240.15c3-1(c)(2)(vi)(J).

security, and based on this process, would have to determine that the investment has only a "minimal amount of credit risk."

Under the proposed amendments, a broker-dealer, when assessing credit risk, could consider the following factors, to the extent appropriate, with respect to each security:[28]

- Credit spreads (i.e., whether it is possible to demonstrate that a position in commercial paper, nonconvertible debt, and preferred stock is subject to a minimal amount of credit risk based on the spread between the security's yield and the yield of Treasury or other securities, or based on credit default swap spreads that reference the security);
- Securities-related research (i.e., whether providers of securities-related research believe the issuer of the security will be able to meet its financial commitments, generally, or specifically, with respect to securities held by the broker-dealer);
- Internal or external credit risk assessments (i.e., whether credit assessments developed internally by the broker-dealer or externally by a credit rating agency, irrespective of its status as an NRSRO, express a view as to the credit risk associated with a particular security);
- Default statistics (i.e., whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a minimal amount of credit risk);
- Inclusion on an index (i.e., whether a security, or issuer of the security, is included as a component of a recognized index of instruments that are subject to a minimal amount of credit risk);

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28 This list of factors is not meant to be exhaustive or mutually exclusive.

- Priorities and enhancements (i.e., the extent to which a security is covered by credit enhancements, such as overcollateralization and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions);
- Price, yield and/or volume (i.e., whether the price and yield of a security or a credit default swap that references the security are consistent with other securities that the broker-dealer has determined are subject to a minimal amount of credit risk and whether the price resulted from active trading); and
- Asset class-specific factors (e.g., in the case of structured finance products, the quality of the underlying assets).

To establish a basis for a haircut of less than 15% for commercial paper, nonconvertible debt, or preferred stock, a broker-dealer would have to establish, maintain, and enforce written policies and procedures for determining the creditworthiness of a security acquired by the firm. The range and type of specific factors considered would vary depending on the particular securities that are reviewed. A broker-dealer that applies a haircut below 15%, as described above, would have a greater burden to support its application of that haircut when a creditworthiness finding under one factor is contradicted by a finding under another factor. Further, any broker-dealer that determines that application of the factors specified above do not support a finding of a minimal amount of credit risk would apply the 15% haircut with respect to the subject security, or, if that security does not have a ready market, a 100% haircut.[29]

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[29] A financial instrument that possesses the necessary credit ratings under Rule 15c3-1 is nevertheless subject to the 100% deduction required by the rule if the financial instrument does not have a ready market. For example, commercial paper rated in the third highest credit rating category may not have a ready market and, therefore, would be subject to the 100% deduction. See, e.g., Nandkumar Nayar and Michael S. Rozeff, Ratings, Commercial Paper, and Equity Returns, XLIX J. of Finance 1431, 1433, n.5 (1994) (noting that "issuers with the lowest ratings find that they cannot issue commercial paper in quantity"). The Commission notes that treatment of commercial paper rated in the third highest credit rating as discussed in this release is limited to Rule 15c3-1 only.

Each broker-dealer would be required to preserve for a period of not less than three years, the first two years in an easily accessible place, the written policies and procedures that the broker-dealer establishes, maintains, and enforces for assessing credit risk for commercial paper, nonconvertible debt, and preferred stock. Broker-dealers would be subject to this requirement in the Commission's broker-dealer record retention rule, Exchange Act Rule 17a-4, which the Commission is proposing to amend in conjunction with this rulemaking.[30]

A broker-dealer's process for establishing creditworthiness and its written policies and procedures documenting that process would be subject to review in regulatory examinations by the Commission and self-regulatory organizations. A broker-dealer that applies a haircut of less than 15% for commercial paper, nonconvertible debt, and preferred stock without establishing, maintaining, and enforcing written policies and procedures reasonably designed to assess creditworthiness would be subject to disciplinary action for non-compliance with the rule and could be required to recalculate its net capital.

The Commission preliminarily believes that these new standards would enable broker-dealers to make the net capital computations required under the Net Capital Rule reflect the market and credit risk inherent in particular commercial paper, nonconvertible debt, and preferred stock.[31] The Commission also recognizes that credit ratings may provide useful information to institutional and retail investors as part of the process of making an investment decision. The requirements of the current rule are based on the practice of many NRSROs to have at least eight categories of ratings for debt securities, with the top four ratings commonly

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30 Specifically, the Commission is proposing to adopt a new paragraph (b)(13) of Rule 17a-4, which would require broker-dealers to preserve the written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness of nonconvertible debt, preferred stock, and commercial paper under the Net Capital Rule.

31 See Uniform Net Capital Rule, Exchange Act Release No. 13635 (Jun. 16, 1977), 42 FR 31778 (Jun. 23, 1977).

referred to in the industry as "investment grade." Although the proposed amendments do not use the term "investment grade," they are meant to capture securities that should generally qualify for that designation, without placing undue reliance on third-party credit ratings.

Currently, the Net Capital Rule distinguishes between those securities that are rated in one of the three highest categories by an NRSRO (i.e., for commercial paper) and those securities that are rated in one of the four highest ratings by an NRSRO (i.e., for nonconvertible debt and preferred stock). The proposed amendments would eliminate the distinction among types of securities. Instead, each of the three classes of securities would be subject to the same requirements under the proposed amendments.

According to data collected by the Commission, of the approximately 5,060 broker-dealers registered with the Commission as of year-end 2009, approximately 480 broker-dealers maintained proprietary positions in debt securities at that time.[32] Thus, it appears that only a small percentage of active broker-dealers registered with the Commission would be impacted by the proposed amendments. The Commission preliminarily believes, based on its oversight activities, that many of the broker-dealers with substantial proprietary positions in debt securities already make independent assessments of creditworthiness based on the types of factors identified in the proposed amendments.

As noted above, the Commission does not intend through the proposed amendments to narrow or broaden the range of securities that generally qualify for reduced haircuts under the

32 This number was obtained by reviewing broker-dealer Financial and Operational Combined Single (or "FOCUS") Reports for 2009 year-end and then calculating how many firms reported holding proprietary debt positions. For FOCUS Part II filers, the balances examined were "Bankers Acceptances" and "Corporate Debt." For FOCUS CSE filers, the balances examined were: "Money Market Instruments," "Private Label Mortgage Backed Securities," "Other Asset Backed Securities," and "Corporate Debt." For Part IIA filers, the balance examined was "Debt Securities." Broker-dealers that hold preferred stock also may hold positions in debt securities. However, because preferred stock is not a separate line item on the FOCUS Report, broker-dealers that hold only preferred stock and not other debt securities are not included in this estimate.

Net Capital Rule as currently written. The Commission recognizes that broker-dealers, when purchasing for their proprietary accounts, provide a substantial source of capital for issuers of commercial paper, nonconvertible debt, and preferred stock. Accordingly, any significant change in practice by broker-dealers, whether because of potential compliance costs, difficulties in applying the proposed criteria or minimal credit risk standard, or other factors, that results in a change in the general allocation of such securities in proprietary accounts could have unintended consequences. Accordingly, the Commission is interested in receiving comment on the potential impact of the proposed amendments on the capital markets generally, and on capital raising efforts by issuers of the affected types of securities specifically, and on how any potential effect could be mitigated or eliminated.

The Commission requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following specific questions:

- Do broker-dealers that would be subject to the proposed amendments either already have processes in place for determining creditworthiness of commercial paper, nonconvertible debt, and preferred stock or have the financial sophistication and the resources necessary to adopt such processes without undue effort or expense? Are there particular types of broker-dealers that would not be capable of meeting this new standard without undue hardship? In what ways and to what extent, if any, would establishing and implementing procedures for determining creditworthiness in lieu of using a credit rating disproportionately impact medium-sized and smaller broker-dealers? Commenters who believe that medium-sized and smaller broker-dealers would be disproportionately affected by these amendments, should describe the firms that would be adversely impacted, as well as provide suggestions as to how the proposal could be amended to accommodate them.

- With respect to the factors a broker-dealer could consider, would the use of these factors in lieu of credit ratings reduce undue reliance on a third party's assessment of credit risk? To what extent, if any, is there a risk that undue reliance will shift from relying on a credit rating to relying on some other third party assessment of creditworthiness?
- What is the potential impact of moving from an objective standard to a more flexible standard? Is there the potential that a broker-dealer's evaluations of creditworthiness may be second-guessed? If so, how might the prospect of being second-guessed impact a broker-dealer's evaluation of minimal credit risk and the appropriate haircuts to take for purposes of the broker-dealer's net capital calculation?
- If broker-dealers establish and implement procedures for determining creditworthiness, some broker-dealers may determine that a security qualifies for a reduced haircut when it would not have qualified for a reduced haircut under the current NRSRO standard. Alternatively, some broker-dealers may determine that a security does not qualify for a reduced haircut when the security would have qualified for a reduced haircut under the current standard. Describe the potential impact on capitalization and the efficient allocation of capital under these two scenarios and the likelihood of each occurring. In addition, with respect to the first scenario, describe the potential impact on the objective of Rule 15c3-1, which, among other things, is to protect investors by enabling a broker-dealer, if the firm experiences financial difficulty, to be in a position to meet all obligations to customers and counterparties

and generate resources to wind-down its operations in an orderly manner without the need of a formal proceeding.

- What are the risks of using internal processes to make credit determinations and how could these risks be addressed? For example, would broker-dealers be likely to adopt procedures that minimize the credit risk associated with a particular security in order to minimize capital charges? How could this risk be addressed?
- Are there other factors a broker-dealer should use when determining creditworthiness? Should the Commission mandate that broker-dealers consider each factor in this release when assessing a security's credit risk? Should the list of factors be included in the text of Rule 15c3-1?
- Should the Commission place conditions on the ability of a broker-dealer to outsource factors related to the determination of creditworthiness to a third party? If the determination of factors related to creditworthiness is outsourced, how can the Commission determine that the outsourced determination meets the proposed standard?
- How often should a broker-dealer be required to update its assessment of a specific security to ensure the broker-dealer's determination of creditworthiness remains current? Should the rule contain a requirement that the assessment be updated after a specific period of time? Should the Commission limit the ability of a broker-dealer to outsource the monitoring of its determination of creditworthiness?
- Should the Commission require that the persons responsible for developing a broker-dealer's internal processes and applying them to possible positions in individual

securities for purposes of the Net Capital Rule be separate from employees who make proprietary investment decisions for the broker-dealer?

- What would be the appropriate level of regulatory oversight of a broker-dealer's credit determination processes? Should the Commission describe in more detail how examiners will examine these processes? How should a broker-dealer be able to demonstrate to regulators the adequacy of the processes that it adopts and that it is following them?
- Should the Commission require the securities industry self-regulatory organizations to set appropriate standards for broker-dealers to use in evaluating creditworthiness and evaluating individual positions in commercial paper, nonconvertible debt, and preferred stock for net capital purposes?
- Should the Commission require broker-dealers to create and maintain records of creditworthiness determinations? If so, what records should be required to be maintained and how should they be described in a rule? Are there standard records that are used when making creditworthiness determinations that the Commission could require broker-dealers to keep? Are there other measures the Commission could consider to reduce the risk that broker-dealers will adopt inadequate processes or fail to adhere to them?
- Rather than referencing a list of factors that broker-dealers could consider, should the rule reference a single or limited set of factors (e.g., credit spreads)? Could a simpler approach adequately capture the risks of holding the full range of securities covered by the rule?

- Are there alternate and more reliable means of establishing creditworthiness for purposes of the Net Capital Rule? Please include detailed descriptions.
- Should the Commission define "minimal amount of credit risk"? Commenters who believe the Commission should define this term should include a detailed description of what should be included in the definition.

2. Proposed Amendments to Appendix A to Rule 15c3-1

Appendix A to Rule 15c3-1 allows broker-dealers to employ theoretical option pricing models in determining net capital requirements for listed options and related positions.[33] Broker-dealers may also elect a strategy-based methodology.[34] The purpose of Appendix A is to simplify the net capital treatment of options in order to reflect the risk inherent in options and related positions.[35]

Under Appendix A, broker-dealers' proprietary positions in "major market foreign currency" options receive more favorable treatment than options for all other currencies when using theoretical option pricing models to compute net capital deductions. The term "major market foreign currency" is currently defined to mean "the currency of a sovereign nation whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and for which there is a substantial inter-bank forward currency market."[36]

With respect to the definition of the term "major market foreign currency," the Commission proposes to remove from that definition the phrase "whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating

33 17 CFR 240.15c3-1a.

34 Id.

35 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

36 17 CFR 240.15c3-1a(b)(1)(i)(C).

organizations." The change would modify the definition of that term to include foreign currencies only "for which there is a substantial inter-bank forward currency market." The Commission also is proposing to eliminate the specific reference in the rule to the European Currency Unit (ECU), which is identified by the rule as the only major market foreign currency under Appendix A.[37] However, because of the establishment of the euro as the official currency of the euro-zone, a specific reference to the ECU is no longer needed. The Commission preliminarily believes that specific reference to the euro also is not necessary, as it is a foreign currency with a substantial inter-bank forward currency market.

The Commission requests comment on all aspects of the proposed amendments to Appendix A to the Net Capital Rule. In addition, the Commission requests comment on the following specific questions:

- Is the proposed definition of "major market foreign currency" sufficiently clear to allow broker-dealers to determine which currencies qualify as major market foreign currencies?
- It is not the intention of the Commission to change the currencies that meet the definition of "major market foreign currency" under this rule. Does the new definition of "major market foreign currency" achieve this goal? Does the Commission need to keep an example of a "major market foreign currency" in the definition?
- How should the Commission distinguish between major market foreign currencies and all other currencies? Should the rule provide that broker-dealers can apply for a Commission determination (e.g., in the form of an Order or other Commission action)

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37 Id.

that a currency be considered a major market foreign currency under Appendix A to Rule 15c3-1? Should a list be created and published on the Commission's website? Should the Commission rely on other lists, such as the list of member countries of the Organization for Economic Co-Operation and Development?[38] Should the determination be made by one of the self-regulatory organizations?

- Should the Commission replace the language in Appendix A to Rule 15c3-1 with a new standard? If so, what should that standard be? Should the Commission use the same standard of creditworthiness and require the same type of process that it has proposed above for Rule 15c3-1?

3. Proposed Amendments to Appendix E to Rule 15c3-1

Pursuant to Appendix E to Rule 15c3-1, a broker-dealer may apply to the Commission for authorization to use an alternative method for computing capital (i.e., the alternative net capital, or "ANC," computation).[39] Specifically, broker-dealers with internal risk management practices that utilize certain mathematical modeling methods to manage their own business risk, including value-at-risk ("VaR") models and scenario analysis, may apply to use these methods to compute net capital requirements for market risk and derivatives-related credit risk.

Under Appendix E, broker-dealers subject to the ANC computation are required to deduct from their net capital credit risk charges that take counterparty risk into consideration. This counterparty risk determination is currently based on either NRSRO ratings or a dealer's internal counterparty credit rating. To comply with Section 939A of the Dodd-Frank Act, the Commission is proposing to remove paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) of Appendix

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38 See http://www.oecd.org/pages/0,3417,en_36734052_36761800_1_1_1_1_1,00.html.

39 As a condition of approval, applicants must maintain an "early warning" level of at least $5 billion in tentative net capital, minimum levels of at least $1 billion in tentative net capital, and $500 million in net capital. See 17 CFR 240.15c3-1(a)(7) and (c)(15).

E, which base credit risk charges for counterparty risk on NRSRO ratings, and in place of these ratings, require a broker-dealer using the ANC computation to apply a credit risk weight of either 20%, 50%, or 150% with respect to an exposure to a given counterparty based on the internal credit rating the broker-dealer determines for the counterparty.

As a result, a broker-dealer that applies to use the approach set forth in Appendix E to determine counterparty risk would be required, as part of its initial application or in an amendment to the application, to request Commission approval to determine credit risk weights of either 20%, 50%, or 150% based on internal calculations and credit ratings. The Commission notes that all of the firms approved to use models to calculate market and credit risk charges under Appendix E to Rule 15c3-1 have been approved to determine credit ratings using internal ratings rather than ratings issued by NRSROs.[40] Under the proposal, firms that are already approved to use the ANC computation in Appendix E would not need to seek new approval from the Commission. Other broker-dealers applying for ANC computation in Appendix E would be required to seek approval of their methodology for determining internal ratings. A broker-dealer that is applying to use Appendix E and intends to use internal ratings to determine the applicable credit risk weights should so state in its application to the Commission.

As stated above, all of the broker-dealers approved to use Appendix E to Rule 15c3-1 have already developed models approved for use in performing the ANC computation, as well as internal risk management control systems. As such, each firm already employs an internal credit rating method (i.e., a non-NRSRO credit rating method) that would, under the proposed amendments, become the only option for determining the applicable credit risk weight.

[40] Currently six broker-dealers are approved to use the ANC computation in Appendix E to Rule 15c3-1.

The Commission generally requests comment on all aspects of the proposed amendments to Appendix E to Rule 15c3-1. In addition, the Commission requests comment on the following specific questions:

- Should the Commission replace provisions in Appendix E to Rule 15c3-1 with a new standard? If so, what should that standard be? For example, should the Commission use the same standard of creditworthiness that it has proposed above for commercial paper, nonconvertible debt, and preferred stock?
- Should the Commission continue to use credit risk weights of 20%, 50%, or 150%? If not, what risk weights should the Commission require be applied?
- Should broker-dealers that are already approved to use Appendix E be required to seek a new determination by the Commission of the credit risk weights assigned to their internal ratings scale?

4. Proposed Amendments to Appendix F to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB

Appendix F to the Net Capital Rule sets forth a program for OTC derivatives dealers that allow them to use an alternative approach to computing net capital deductions, subject to certain conditions.[41] Under Appendix F, OTC derivatives dealers with strong internal risk management practices may utilize the mathematical modeling methods used to manage their own business

[41] OTC derivatives dealers are a special class of broker-dealers that are exempt from certain broker-dealer requirements, including membership in a self-regulatory organization (17 CFR 240.15b9-2), regular broker-dealer margin rules (17 CFR 240.36a1-1), and application of the Securities Investor Protection Act of 1970 (17 CFR 240.36a1-2). OTC derivative dealers are subject to special requirements, including limitations on the scope of their securities activities (17 CFR 240.15a-1), specified internal risk management control systems (17 CFR 240.15c3-4), recordkeeping obligations (17 CFR 240.17a-3(a)(10)), and reporting responsibilities (17 CFR 240.17a-12). They are also subject to alternative net capital treatment (17 CFR 240.15c3-1(a)(5)). See 17 CFR 240.15a-1, Preliminary Note.

risk, including VaR models and scenario analysis, to compute deductions from net capital for market and credit risks arising from OTC derivatives transactions.[42]

Under Appendix F to the Net Capital Rule, OTC derivatives dealers are required to deduct from their net capital credit risk charges that take counterparty risk into consideration. As part of this deduction, the OTC derivatives dealer must apply a counterparty factor of either 20%, 50%, or 100%.[43] In addition, the OTC derivatives dealer must take a concentration charge where the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital.[44] The counterparty factor (i.e., 20%, 50%, or 100%) to apply currently is based on either NRSRO ratings or the firm's internal credit ratings.[45] The concentration charges also are based on either NRSRO ratings or the firm's internal credit ratings. All of the firms approved to use models to calculate market and credit risk charges under Appendix F to Rule 15c3-1 have been approved to determine credit risk charges using internal credit ratings.[46] To comply with Section 939A of the Dodd-Frank Act, the Commission is proposing to amend Appendix F to Rule 15c3-1 and to make conforming changes to Form X-17A-5, Part IIB.

Specifically, the Commission is proposing to revise paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Appendix F to the Net Capital Rule, which permit the use of NRSRO ratings when determining counterparty risk. As a result of these revisions, an OTC derivatives dealer that applies to use the approach set forth in Appendix F to determine counterparty credit risk charges would be required, as part of its initial application or in an amendment to the

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42 The minimum net capital requirements for an OTC derivatives dealer are tentative net capital of at least $100 million and net capital of at least $20 million. See 17 CFR 240.15c3-1(a)(5) and (c)(15).

43 17 CFR 240.15c3-1f(d)(2).

44 17 CFR 240.15c3-1f(d)(3).

45 See 17 CFR 240.15c3-1f(d)(2) and (4).

46 Currently four firms are using Appendix F to the Net Capital Rule.

application, to request Commission approval to determine credit ratings using internal ratings rather than ratings issued by NRSROs. Under the proposal, firms that are already approved to use internal ratings pursuant to Appendix F would not need to seek new approval from the Commission. An OTC derivatives dealer that is applying to use Appendix F and intends to use internal ratings to determine the applicable credit risk weights should so state in its application to the Commission.

As stated above, all of the approved firms have already developed models to calculate market and credit risk under the alternative net capital calculation methods set forth in Appendix F. As such, each firm already employs a non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for calculating credit risk charges.

Based on these proposed amendments to Appendix F to Rule 15c3-1, the Commission is proposing conforming changes to the General Instructions to Form X-17A-5, Part IIB. This form constitutes the basic financial and operational report required of OTC derivatives dealers to be filed with the Commission. Under the heading "Computation of Net Capital and Required Net Capital" and before the section "Aggregate Securities and OTC Derivatives Positions," the Commission is proposing conforming changes to the section "Credit risk exposure." This section explains the counterparty charges for OTC derivatives dealers based on the language in Appendix F to Rule 15c3-1. Therefore, the Commission is proposing that all changes made to Appendix F to Rule 15c3-1 also be made to the section "Credit risk exposure" under the heading "Computation of Net Capital and Required Net Capital" in the General Instructions to Form X-17A-5, Part IIB.

The Commission generally requests comment on all aspects of the proposed amendments to Appendix F to Rule 15c3-1 and the conforming changes to the General Instructions to Form

X-17A-5, Part IIB. In addition, the Commission requests comment on the following specific questions:

- Should the Commission replace the provisions in Appendix F to Rule 15c3-1 with a new standard? If so, what should that standard be? Should the Commission use the same standard of creditworthiness that it has proposed above for commercial paper, nonconvertible debt, and preferred stock?
- Should the Commission continue to use counterparty factors of 20%, 50%, or 100%? If not, what counterparty factors should the Commission require be applied?
- Should the OTC derivatives dealers that have been approved to use Appendix F be required to submit an amendment to their applications to use internal credit ratings?

5. Proposed Amendment to Appendix G to Rule 15c3-1

The Commission is also proposing a conforming amendment to Appendix G to Rule 15c3-1. Under Appendix G, a broker-dealer that uses the ANC computation can only do so if its ultimate holding company agrees to provide the Commission with additional information about the financial condition of the ultimate holding company and its affiliates. Appendix G applies to an ultimate holding company that has a principal regulator and is intended to ensure that the Commission can obtain certain information designed to help the Commission assess the financial and operational health of the ultimate holding company and its potential impact on the risk exposure of the broker-dealer.[47]

The proposed amendment to Appendix G would delete references in that appendix to the provisions of Appendix E that the Commission is proposing to delete as described above. These references are found in paragraph (a)(3)(i)(F) to Appendix G. Because of the proposed

[47] Currently, each broker-dealer that uses the ANC computation has an ultimate holding company that has a principal regulator. As a result of both changes to the Commission's regulatory programs and the Dodd-Frank Act, the Commission is no longer regulating ultimate holding companies.

amendments to Appendix E described above, the references to Appendix E in Appendix G would no longer be accurate.

The Commission generally requests comment on all aspects of the proposed amendment to Appendix G to Rule 15c3-1.

B. PROPOSED AMENDMENT TO EXHIBIT A TO RULE 15c3-3

Exchange Act Rule 15c3-3 (the "Customer Protection Rule") protects customer funds and securities held by broker-dealers. In general, the Customer Protection Rule has two parts. The first part requires a broker-dealer to have possession or control of all fully paid and excess margin securities of its customers. In this regard, a broker-dealer must make a daily determination in order to comply with this aspect of the rule.

The second part covers customer funds and requires broker-dealers subject to the rule to make a periodic computation to determine how much money it is holding that is either customer money or money obtained from the use of customer securities ("credits"). From that figure, the broker-dealer subtracts the amount of money which it is owed by customers or by other broker-dealers relating to customer transactions ("debits"). If the credits exceed debits after this "reserve formula" computation, the broker-dealer must deposit the excess in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (a "Reserve Account"). If the debits exceed credits, no deposit is necessary. Funds deposited in a Reserve Account cannot be withdrawn until the broker-dealer completes another computation that shows that the broker-dealer has on deposit more funds than the reserve formula requires.

The Customer Protection Rule is designed to prevent broker-dealers from using customer money to finance their business, except as related to customer transactions, since customer funds (the credits) can be offset only by customer-related transactions (the debits). As a result, broker-dealers must provide the capital to finance their trades and firm activities and may not use customers' funds for such purposes.

Exhibit A to Rule 15c3-3 contains the formula that a broker-dealer must use to determine its reserve requirement. Under Note G to Exhibit A, a broker-dealer may include required customer margin for transactions in security futures products as a debit in its reserve formula computation if that margin is required and on deposit at a clearing agency or derivatives clearing organization that:

1. Maintains the highest investment-grade rating from an NRSRO;
2. Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits;
3. Maintains at least $3 billion in margin deposits; or
4. Obtains an exemption from the Commission.[48]

Requiring a clearing agency or a derivatives clearing organization to meet certain minimum criteria before margin deposits with that entity may be included as a debit in a broker-dealer's customer reserve formula is consistent with the customer protection function of Rule 15c3-3, because margin that is posted for customer positions in security futures products constitutes an unsecured receivable from the clearing agency or organization. Accordingly, this requirement is intended to provide reasonable assurance that customer margin deposits related to security futures products are adequately protected.

The Commission is proposing to remove the first criterion described above (i.e., the highest investment-grade rating from an NRSRO). The Commission notes that the criteria are

[48] 17 CFR 240.15c3-3a, Note G.

disjunctive and, therefore, a clearing agency or derivatives clearing organization needs to satisfy only one criterion to permit a broker-dealer to treat customer margin as a reserve formula debit. Consequently, the Commission preliminarily believes that the proposed amendment would not lessen the protections for customer funds and securities. Furthermore, while one potential criterion would be removed, there is only one clearing agency for security futures products (namely, the Options Clearing Corporation) and that clearing agency would continue to qualify under each of the other applicable criteria. Moreover, if a new registered clearing agency or derivatives clearing organization could not meet one of the remaining criteria, a broker-dealer may request an exemption for the clearing agency or organization under the rule.[49]

The Commission preliminarily believes that eliminating the reference to NRSRO ratings in Note G to Exhibit A to Rule 15c3-3 will continue to advance the goals of the Customer Protection Rule by ensuring the long-term financial strength of clearing agencies and derivatives clearing organizations holding customer margin for positions in security futures products.[50] The Commission preliminarily believes that requiring a registered clearing agency or derivatives clearing organization to comply with one of the three remaining criteria will adequately serve the customer protection purpose of Rule 15c3-3.

The Commission generally requests comment on all aspects of the removal of paragraph (b)(1)(i) of Note G to Rule 15c3-3a. In addition, the Commission requests specific comment on the following questions:

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49 The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. See paragraph (b)(iv) of Rule 15c3-3a, Note G.

50 See Rule 15c3-3 Reserve Requirements for Margin Related to Security Futures Products, Exchange Act Release No. 50295 (Aug. 31, 2004), 69 FR 54182 (Sep. 7, 2004).

- Should the Commission replace the language in paragraph (b)(1)(i) of Note G with a new standard? If so, what should that standard be? Should the Commission use the same standard of creditworthiness that it has proposed above for commercial paper, nonconvertible debt, and preferred stock?
- What factors should the Commission take into account when considering the potential regulatory compliance costs of removing references to NRSROs from paragraph (b)(1) of Note G? Commenters should include detailed descriptions of any potential costs.
- Do the guidelines offered by current paragraphs (b)(1)(ii)-(iv) of Note G provide sufficient means by which a registered clearing agency or derivatives clearing organization could be judged to meet the requirements of paragraph (b)(1) of Note G? If not, what additional information should be added to meet the requirements of paragraph (b)(1) of Note G?
- Are there clearing agencies or derivatives clearing organizations that would not meet the remaining standards contained in paragraph (b)(1) of Note G?

C. EXCEPTIONS FOR INVESTMENT GRADE NONCONVERTIBLE AND ASSET-BACKED SECURITIES IN RULES 101 AND 102 OF REGULATION M

As a prophylactic anti-manipulation set of rules, Regulation M is designed to preserve the integrity of the securities trading market as an independent pricing mechanism by prohibiting activities that could artificially influence the market for an offered security. Rules 101 and 102 of Regulation M specifically prohibit issuers, selling security holders, distribution participants, and any of their affiliated purchasers, from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase a "covered security" until the applicable restricted period has ended.[51]

Rules 101(c)(2) and 102(d)(2) currently except "investment grade nonconvertible and asset-backed securities."[52] These exceptions apply to nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. In accordance with Section 939A(b) of the Dodd-Frank Act, the Commission is proposing to remove the references to credit ratings in Rules 101(c)(2) and 102(d)(2) and replace them with new standards relating to the trading characteristics of covered securities.

1. Background

Historically, the Rule 101(c)(2) and 102(d)(2) exceptions trace back to a no-action position taken by the staff in 1975 regarding Exchange Act Rule 10b-6, the predecessor to Rules 101 and 102.[53] The lead underwriter of an offering of debentures had written the staff seeking interpretive guidance because Rule 10b-6 prohibited it from making markets in the debt securities of the same issuer other than the security being distributed, as these other securities could be considered "of the same class and series" under Rule 10b-6(a) as the security being distributed.[54] The staff, with the Commission's concurrence, provided no-action relief permitting dealers participating in a distribution of debt securities of an issuer to bid for or

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51 "Covered security" is defined as "any security that is the subject of a distribution or any reference security," and "reference security" is defined as "a security into which a security that is the subject of a distribution ('subject security') may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security." 17 CFR 242.100.

52 17 CFR 242.101(c)(2) and 242.102(d)(2).

53 Letter from Robert C. Lewis, Associate Director, the Division of Market Regulation, the Commission to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975).

54 As explained below, the activity for which relief was sought in this letter would be permissible under Rules 101 and 102 today even without the investment grade securities exceptions or no action relief because of a change in the securities covered under Rules 101 and 102 as compared to the securities covered under Rule 10b-6.

purchase other outstanding debt securities of such issuer, but required that the new issue and outstanding issues be subject to certain investment grade ratings.[55] In granting relief, the staff emphasized representations from the underwriter that (1) "because the non-convertible bonds of particular issuers are not considered unique and because of the concept of relative value, it is simply not possible to manipulate the price of a corporate bond that has broad investor interest" and (2) purchasing activities in such securities generally are "unlikely to materially affect the price of [a nonconvertible debt security being offered] because of the availability of large amounts of securities of other issuers which have comparable quality yield [spreads]."[56]

In 1983, the Commission amended the rule to fully except all investment grade nonconvertible debt securities from Rule 10b-6.[57] At that time, the Commission also added an exception for investment grade nonconvertible preferred securities. In proposing the rule changes, the Commission stated that "it is very difficult, if not impossible, to manipulate the price of investment grade debt. Investment grade debt securities are generally thought to trade in accordance with the concept of relative value, i.e., such securities are to a large degree fungible,[58] so that investors generally evaluate new offerings by looking at comparably rated securities of other issuers."[59]

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55 Letter from Robert C. Lewis, Associate Director, the Division of Market Regulation, the Commission, to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975).

56 Id.

57 Prohibitions Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 19565 (Mar. 4, 1983), 48 FR 10628 (Mar. 14, 1983). See also Prohibitions Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 18528 (Mar. 3, 1982), 47 FR 11482 (Mar. 16, 1982). The 1975 letter included a number of other requirements that were not codified. Letter from Robert C. Lewis, Associate Director, the Division of Market Regulation, the Commission, to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975).

58 With regard to whether investment grade nonconvertible preferred securities are largely fungible with investment grade nonconvertible preferred securities of other issuers, the Commission noted that "[n]onconvertible preferred securities possess some of the attributes of debt securities and, when rated investment grade, generally trade on the basis of their value in relation to comparably-rated offerings of other issuers." Prohibitions Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 19565 (Mar. 4, 1983), 48 FR 10628 (Mar. 14, 1983). The Commission further noted that the exceptions are based on the concept "that investment grade debt and preferred securities are traded on the

When Rules 101 and 102 of Regulation M were adopted, the Commission substituted the concept of "same class and series" in Rule 10b-6 with the concept of "covered securities." The Commission clarified that as a result of this change, "bids for and purchases of outstanding nonconvertible debt securities are not restricted unless the security being purchased is identical in all of its terms to the security being distributed."[60] The effect of this change in application was that "as a practical matter, Rule 101 and Rule 102 will have very limited impact on debt securities, except for the rare situations where selling efforts continue over a period of time."[61] In contrast, under Rule 10b-6, bids for or purchases of debt securities of the issuer other than those being distributed could be prohibited if they were similar to the distributed securities in coupon interest rate and maturity date.

Investment grade asset-backed securities were also added to the exception with the adoption of Regulation M.[62] The application of the exception to these securities was based on the premise that asset-backed securities also trade primarily on the basis of yield spread and credit rating and that asset-backed securities investors are concerned with "the structure of the class of securities and the nature of the assets pooled to serve as collateral for those securities."[63]

2. 2008 Proposal

In 2008, the Commission proposed to eliminate NRSRO references to address concerns that such references contributed to undue reliance on NRSRO ratings by market participants.

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basis of their yields and financial ratings and therefore are largely fungible." Id. The Commission solicits comment below as to whether this understanding with respect to the fungibility of nonconvertible preferred securities remains accurate.

59 Prohibitions Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 18528 (Mar. 3, 1982), 47 FR 11482 (Mar. 16, 1982).

60 Anti-manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997). The Commission noted that "Rule 101 does not apply to a security if there is a single basis point difference in coupon rates or a single day's difference in maturity dates, as compared to the security in distribution." Id.

61 Id.

62 Id.

63 Anti-manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997).

Specifically, the Commission proposed to remove references to NRSRO ratings from the determination of whether investment grade nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities would be eligible for the Rule 101(c)(2) and 102(d)(2) exceptions, and instead except nonconvertible debt securities and nonconvertible preferred securities based on the "well-known seasoned issuer" ("WKSI") concept of Securities Act Rule 405 and except asset-backed securities that are registered on Form S-3 ("2008 Regulation M Proposals").[64]

Those commenters that addressed the proposed Regulation M changes expressed uniform opposition to the proposed amendments.[65] Many of these commenters stated their view that the proposal is not necessary to address concerns about investors' undue reliance on NRSRO ratings.[66] Commenters also stated that, because the 2008 Regulation M Proposals would have altered the scope of the exceptions for investment grade nonconvertible debt securities, investment grade nonconvertible preferred securities, and asset-backed securities, they would have placed new burdens on issuers and underwriters by imposing the restrictions of Regulation M on currently excepted investment grade securities.[67] Additionally, commenters expressed the

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64 Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008).

65 We received five comment letters that specifically addressed the Regulation M proposals and each opposed the proposals. See Letters from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association ("ABA"), to Florence E. Harmon, Acting Secretary, dated Oct. 10, 2008 ("ABA Letter"); Robert Dobilas, CEO and President, Realpoint LLC, to Secretary, dated Sep. 8, 2008; Letter from Jeremy Reifsnyder and Richard Johns, Co-chairs, American Securitization Forum ("ASF") Credit Rating Agency Task Force, to Florence E. Harmon, Acting Secretary, dated Sep. 5, 2008 ("ASF Letter"); Deborah A. Cunningham and Boyce I. Greer, Co-chairs, Securities Industry and Financial Markets Association ("SIFMA") Credit Rating Agency Task Force, to Florence E. Harmon, Acting Secretary, dated Sep. 4, 2008 ("SIFMA Letter 1"); and Mayer Brown LLP to Florence E. Harmon, Acting Secretary, dated Sep. 4, 2008 ("Mayer Brown Letter"). There were comment letters supportive of the Commission's effort to minimize undue reliance on NRSRO ratings by market participants, however, these commenters did not discuss Regulation M. See, e.g., Letter from Suzanne C. Hutchinson, Executive Vice President, Mortgage Insurance Companies of America, to Florence E. Harmon, Acting Secretary, dated Sep. 5, 2008.

66 See, e.g., SIFMA Letter 1 ("Regulation M is primarily directed at the actions of the issuers of securities and the investment banks who underwrite them; in contrast, the investors that the Commission is concerned with are not users of Regulation M").

67 ABA Letter, SIFMA Letter 1.

view that certain high yield securities that are currently subject to Regulation M, but are arguably more vulnerable to manipulation than securities currently excepted from Regulation M, would have been excepted from Rules 101 and 102 of Regulation M under the 2008 Regulation M Proposals.[68] These commenters did not suggest any substitute to the proposed rule changes.[69]

3. 2009 Comment Period Re-opening

In 2009, the Commission deferred consideration of the 2008 Regulation M Proposals and, in light of the uniform opposition by commenters and continuing concern regarding the undue influence of NRSRO ratings, the Commission reopened the comment period for the 2008 Regulation M Proposals.[70] The Commission received three additional comment letters.[71] Of these, two reiterated earlier objections,[72] and the third argued that the 2008 Regulation M Proposals would have adverse effects on foreign sovereign issuers of debt securities.[73] Although the Commission invited commenters to suggest alternative proposals, no new alternatives were suggested.

4. Current Proposal

In accordance with Section 939A(b) of the Dodd-Frank Act, and in light of the opposition to the 2008 Regulation M Proposals, the Commission is proposing new standards to replace the reference to NRSRO credit ratings in the Regulation M exceptions. Specifically, the

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68 Id.

69 The ABA did, however, suggest that should the Commission insist on using the WKSI standard for investment grade nonconvertible debt and investment grade nonconvertible preferred securities, it do so only as an alternative to the current exceptions at Rules 101(c)(2) and 102(d)(2). ABA Letter. However, the ABA expressed its "strong[] belie[f] that the Commission should retain the current exceptions." Id.

70 References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60790 (Oct. 5, 2009); 74 FR 52374 (Oct. 9, 2009).

71 Letter from Mary Keogh, Managing Director, Regulatory Affairs and Daniel Curry, President, DBRS, Inc., to Elizabeth M. Murphy, Secretary, dated Nov. 13, 2009 ("DBRS Letter"); Letter from Steven G. Tepper, Arnold & Porter LLP, to the Honorable Mary L. Schapiro, Chairman, dated Dec. 8, 2009 ("Arnold & Porter Letter"); and Letter from Sean C. Davy, Managing Director, Corporate Credit Markets Division, SIFMA, to Elizabeth M. Murphy, Secretary, dated Dec. 8, 2009 ("SIFMA Letter 2").

72 DBRS Letter and SIFMA Letter 2.

73 Arnold & Porter Letter.

Commission proposes to except nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities from Rules 101 and 102 if they: (1) are liquid relative to the market for that asset class; (2) trade in relation to general market interest rates and yield spreads; and (3) are relatively fungible with securities of similar characteristics and interest rate yield spreads.

The proposed standards are an attempt to codify the subset of trading characteristics of investment grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that make them less prone to the type of manipulation that Regulation M seeks to prevent. The standards are not intended as measures of or proxies for assessments of credit risk, or to provide substitute criteria for whether or not a security would be considered investment grade.

The application of Rules 101 and 102 of Regulation M to debt securities is very limited, as compared to Rule 10b-6. The Commission is interested in comment as to whether and in what circumstances issuers, selling shareholders, distribution participants, and their affiliated purchasers rely on the current exception for investment grade securities (including with respect to specific activities) and, in particular, whether this exception serves a continuing purpose with regard to nonconvertible debt and asset-backed securities. The Commission further solicits comment as to whether, if the application of Rules 101 and 102 of Regulation M to debt securities is in fact quite limited as a practical matter, the current investment grade exception should be eliminated or, alternatively, whether it should be expanded to except from Rules 101 and 102 all nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities (or some subset thereof).

a. Standards

i. Liquid relative to the market for the asset class

In order to qualify for the proposed exception, a nonconvertible debt, nonconvertible preferred, or asset-backed security would need to be liquid relative to the market for that asset class. The Commission believes that a high degree of liquidity is an important consideration in determining which securities should be eligible for the proposed exception from Rules 101 and 102. In general, the existence of substantial liquidity is indicative of an established, efficient market with a large number of participants, which is less likely to be subject to the type of manipulation with which Regulation M is concerned. Since this exception would apply primarily to a security for which the distribution continues after the security begins to trade, the Commission preliminarily believes that persons seeking to rely on this exception would be able to adequately identify securities that meet this standard.

The Commission seeks comment on the standards that may be indicative of relative liquidity, such as the size of the issuance, the percentage of the average daily trading volume by persons other than the persons seeking to rely on the exception, and the number of market makers in the security being distributed other than those seeking to rely on the exception.[74] Other factors that could be considered include the overall trading volume of the security, the number of liquidity providers who participate in the market for the security, trading volume in similar securities or other securities from the same issuer, overall liquidity of all outstanding debt issued by the same issuer, how quickly an investor could be expected to be able to sell the

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[74] See, e.g., Letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, the Commission, to Alan J. Sinsheimer, Sullivan & Cromwell (Jan. 12, 2000).

security after purchase, and, in the case of asset-backed securities, the liquidity and nature of the underlying assets.[75]

ii. Trade in relation to general market interest rates and yield spreads

A nonconvertible debt security, nonconvertible preferred security, or asset-backed security also would need to trade at prices that are primarily driven by general market interest rates and spreads applicable to a broad range of similar securities. This standard would limit the exception's availability to those securities that trade in relation to changes in broader interest rates (i.e., based on their comparable yield spreads), as opposed to securities that trade in relation to issuer-specific information or credit quality.[76] This characteristic affords market participants the ability to use general market rates to make their own estimates of the value of such a security and whether such security is trading at prices outside of expected ranges. It would be more difficult for market participants to make such an independent judgment if the security traded in an idiosyncratic fashion based primarily on its specific characteristics, such that the traded price of the security could not readily be compared to similar issues. As noted above, investment grade nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities were originally excepted in part because they trade in relation to general market interest rates and yield spreads.

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75 This list is merely illustrative and should not be considered a necessary or exhaustive list of the factors that could reasonably be considered in evaluating liquidity.

76 This was an important distinction for the Commission when adopting the current exceptions. "Investors are therefore more likely to compare yields of new non-investment grade debt offerings with those of outstanding debt securities of the same issuer." Prohibitions Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 18528 (Mar. 3, 1982), 47 FR 11482 (Mar. 16, 1982).

iii. Relatively fungible with securities of similar characteristics and interest rate yield spreads

Finally, a nonconvertible debt, nonconvertible preferred, or asset-backed security would need to be relatively fungible (in terms of trading characteristics) with similar securities, i.e., securities with similar interest rate yield spreads, in order to qualify for the proposed exception. This standard, along with the requirement that the security trade in relation to general market interest rates and yield spreads explained above, is an attempt to codify a further trading characteristic of the investment grade securities that are currently excepted from Rules 101 and 102. Together with the standard regarding trading in relation to general market interest rates and yield spreads, the Commission preliminarily believes that the fungibility requirement would limit the proposed exception to those securities that pose little risk of manipulation.

Being "relatively fungible" for these purposes would not require that the security, for example, be deliverable for a purchase order for a different security, but rather that a portfolio manager would be willing to purchase the security in lieu of another security that has similar characteristics (i.e., yield spreads, credit risk, etc.). Securities with these characteristics would be less prone to market squeezes or other forms of manipulation. Note that in order to satisfy this requirement, a security need not be completely fungible for all purposes with another security that has similar characteristics.

The Commission preliminarily believes that persons seeking to rely on the exception would be able to objectively demonstrate these three standards were met.

b. Evaluation of the Security

The proposal would require the person seeking to rely on the exception to make the determination that the security in question is liquid relative to the market for the asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads. The determination must be made utilizing reasonable factors of evaluation and must be subsequently verified by an independent third party.

Each person seeking to rely on the exception would be required to assess the standards laid out in the proposal with regard to the specific nonconvertible debt, nonconvertible preferred, or asset-backed security being distributed. Persons would be required to exercise reasonable judgment in conducting this analysis. Sole reliance on a third party's determination without any further analysis would not be considered to be based on reasonable judgment. Persons seeking to rely on the exception would need to demonstrate compliance with the requirements of this provision.

c. Third Party Verification

In addition to making a determination that the nonconvertible debt, nonconvertible preferred, or asset-backed security reasonably meets the standards of the proposed exception, a person seeking to rely upon the exception also would be required to obtain a verification of this determination by an independent third party. Each person seeking to rely on the exception would be required to make a reasonable determination of the independence and qualifications of a third party for this purpose, based on the third party's relevant professional background, experience, knowledge, and skills. Counsel to, or other affiliates of, the underwriter or issuer, would not meet the independence requirement.[77] Persons seeking to rely on the exception may be best positioned in the first instance to evaluate all of the factors that would be relevant to the determination, but they also would have an inherent conflict of interest. The third party verification requirement is intended to provide a reliable check on the reasonableness of that determination.

77 This is not an exhaustive list of persons who would not be considered to be independent.

The Commission intends by this proposal generally to except the same types and amounts of securities that are currently excepted in Rules 101(c)(2) and 102(d)(2) without referencing credit ratings. To that end, the Commission is interested in comments on any added costs or other effects that the requirement of independent third party verification in particular may have in distributions of nonconvertible debt, nonconvertible preferred, and asset-backed securities that would result in making the exception less available than it is today. To the extent that the need to obtain a third party verification increases the costs that a person must incur in order to benefit from the exception for these securities from Rules 101 and 102 of Regulation M, the Commission seeks comment as to what those costs are and whether such costs in at least some cases would result in persons who currently rely on the exception determining not to do so. This in turn may effectively expand the circumstances in which Rules 101 and 102 of Regulation M apply, as compared to the status quo. Thus, an increase in costs resulting from the third party verification that is sufficient to alter the behavior of market participants may reduce the practical benefit of the exception.

The Commission also specifically solicits comment regarding the type of entity that would be considered an acceptable independent third party for purposes of this exception. For example, the Commission seeks comment as to whether to limit the acceptable independent third parties to those who could meet the definition of "qualified independent underwriter" for purposes of the SRO rules,[78] which could provide a familiar bright line standard. The Commission also seeks comment as to whether to limit the acceptable independent third parties

[78] See Financial Industry Regulatory Authority ("FINRA") Rule 5121(f)(12). This rule generally requires that a qualified independent underwriter be a FINRA member, have no conflict of interest in the offering, not be an affiliate of a FINRA member that does have a conflict of interest, not beneficially own more than 5% of the class of securities that would give rise to a conflict of interest, have agreed in writing to be a qualified independent underwriter and undertake the legal responsibilities and liabilities of an underwriter under the Securities Act, have specific offering experience, and not have any supervisory associated persons who are responsible for organizing, structuring, or performing due diligence with respect to corporate public offerings of securities that have certain disciplinary histories.

to only entities that are registered with the Commission, which would ensure that the Commission has examination authority over those persons acting as independent third party verifiers. The Commission further seeks comment as to whether the proposal should limit the number of times a person seeking to rely on the exception could rely on the same independent third party.

5. Request for Comment

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support alternative recommendations. Please provide empirical data, when possible, and cite to economic studies, if any, to support alternative approaches.

- How often are these exceptions utilized where no other exception from Rules 101 or 102 of Regulation M exists?
- Should the Commission remove the exception from Rules 101 and 102 of Regulation M for nonconvertible debt securities, nonconvertible preferred securities, and/or asset-backed securities completely? Why or why not? What specific trading activities that currently occur pursuant to the exception would then be prohibited during the restricted period because no other exception is available? What are the advantages and disadvantages of such trading activities? Should the Commission explicitly except any such specific activities in lieu of providing a generic exception for investment grade nonconvertible debt securities, nonconvertible preferred securities, and/or asset-backed securities? What benefits or challenges would this approach create?

- Should the Commission expand the exception to cover all nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities? What activities would then be allowed that were previously prohibited under Rules 101 and 102 of Regulation M? Would these new activities have any manipulative risk? Why or why not?
- Would the nonconvertible debt, nonconvertible preferred, and asset-backed securities excepted in the proposal be more vulnerable to manipulation than securities that meet the existing investment grade standard? Why or why not?
- Are the proposed standards an appropriate substitute for credit ratings in this context? Would the proposal capture the same type and quantity of securities that fall within the current Rule 101(c)(2) and Rule 102(d)(2) exceptions? What effect(s), if any, would the proposed modifications to the current exception have on the markets for nonconvertible debt, nonconvertible preferred and asset-backed securities?
- How difficult and costly in practice would the requirements of the proposed exception be to apply? If the requirements are more difficult or costly to apply, how might this impact the scope of securities subject to the restrictions of Regulation M? For example, to what extent, if any, might a narrower range of securities meet the exceptions as a result of the proposal, if adopted? If fewer securities are excepted from the restrictions of Regulation M, in what ways and to what extent, if any, would this impact the market for those securities that would no longer qualify for the exception?

- Will fewer nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities issues meet the requirements for these exceptions? If so, what impact would this proposal have on the market for new issues of these securities?
- Please discuss whether and to what extent investors rely upon the current Rule 101(c)(2) and 102(d)(2) exceptions for investment grade nonconvertible and asset-backed securities when making a decision to invest in such securities. Please also discuss whether, given that Rules 101 and 102 of Regulation M are directed at distribution participants, issuers, and selling securities holders, Rules 101 and 102 of Regulation M pose any danger of undue reliance on NRSRO ratings.
- Are there factors other than those identified in the proposed standards that influence the trading of such securities? Are there additional standards that the Commission should consider? Are there any that the Commission should remove from the proposal?
- Should the proposed standards apply equally to nonconvertible debt, nonconvertible preferred, and asset-backed securities, or are there other standards that would be relevant to consider based on the type of security involved?
- Would persons needing to use the proposed exception have access to adequate information to determine whether a particular security meets the exception? Why or why not?
- Is the Commission's position (expressed at the time the exception was initially adopted)[79] that preferred securities are generally fungible with similar quality preferred securities still valid? Has the market for preferred securities changed to the

[79] Prohibitions Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 19565 (Mar. 4, 1983), 48 FR 10628 (Mar. 14, 1983).

extent that these securities are no longer generally fungible with similar quality preferred securities? If so, to what extent has the market changed? Rules 101(c)(2) and 102(d)(2) of Regulation M currently except investment grade nonconvertible preferred securities. Is this exception still relevant in the current marketplace for preferred securities? What would be the potential adverse consequences if preferred securities were no longer excepted from Rules 101 and 102?

- With regard to asset-backed securities, should the determination on behalf of the issuer that the security meets the proposed factors be made by the sponsor or depositor of the asset-backed security, or some other person? Please explain. What kinds of conflicts of interest may arise in this situation relating to sponsors or depositors? For instance, the Commission could propose the following rule text: "With respect to an asset-backed security, the term issuer includes a sponsor, as defined in §229.1011 of this chapter, or depositor, as defined in §229.1011 of this chapter, that participates in the issuance of an asset-backed security." Does this further the goal of Regulation M and the reasons for the exception? What benefits or costs would be associated with this change?
- What impact, if any, will the potential costs of obtaining an independent third party verification have on the market for new issues of nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities? If these costs will have an impact, please explain how.
- Other than NRSROs, are there entities such as independent research firms or investment banks not involved in the distribution that would be willing and able to serve as independent third parties for these purposes?

- What additional costs, if any, will the requirement to use an independent third party for purposes of the third party verification proposal add to a distribution as compared to the current requirements of Rules 101(c)(2) and 102(d)(2)?
- Would the independent third party verification, if adopted, alter the amount or types of securities that can rely on the exception?
- What factors should be considered in qualifying an independent third party for purposes of the third party verification proposal?
- Does the independent third party verification requirement adequately address potential issuer, selling shareholder, distribution participant, and affiliated purchaser conflicts of interest?
- Would it be appropriate to utilize the definition, in whole or in part, of "qualified independent underwriter" from the SRO rules in establishing who may be an independent third party for purposes of the third party verification proposal? What are the benefits or drawbacks to utilizing this standard? What other alternatives should the Commission consider?
- The Commission would expect, if such an interpretation would be adopted, that the definition of "qualified independent underwriter" for these purposes would be similar to the requirements of FINRA Rule 5121(f)(12) and generally require that such persons (1) be registered with an SRO; (2) have no conflict of interest in the offering; (3) not be an affiliate of a person that does have a conflict of interest; (4) not beneficially own more than 5% of the class of securities that would give rise to a conflict of interest; (5) have agreed in writing to be a qualified independent underwriter and undertake the legal responsibilities and liabilities of an underwriter

under the Securities Act; (6) have specific offering experience; and (7) not have any supervisory associated persons who are responsible for organizing, structuring, or performing due diligence with respect to corporate public offerings of securities that have certain disciplinary histories. Would all of these requirements be appropriate? Are any of these requirements unnecessary?

- Should the Commission limit the eligibility to be an independent third party for purposes of the third party verification proposal to those registered with the Commission in some capacity? What are the benefits or drawbacks to utilizing this standard? What other alternatives should the Commission consider?
- In order to protect an independent third party verifier's independence, should the Commission limit the frequency with which a person could rely on the same independent third party for purposes of the third party verification proposal?
- Should the Commission instead require only that persons seeking to rely on the exception make a reasonable determination that the proposed factors are present in the security being offered, without any independent third party verification? If so, should the concern about conflicts of interest be addressed and how? What benefits would this approach provide? What other concerns could this approach raise?
- What are the risks of allowing parties to use internal processes to make determinations of reasonableness? For example, would parties be likely to adopt procedures that maximize the opportunity to take advantage of the exception? Would increased cost efficiencies arising from internal processes outweigh the conflicts of interest presented? How likely are there to be instances where a determination under the proposed amendments would result in a party qualifying for the exception when it

would not have qualified under the current standard? How might the Commission attempt to mitigate such risks?

- Should the Commission, in lieu of the third party verification requirement, require that any person seeking to rely on the exception disclose in the offering documents relating to the distribution: (1) that the person is relying on the relevant exception; (2) that the person has undertaken diligent review and, utilizing the factors identified in this proposal, reasonably concluded that the security meets the proposed factors; (3) the factors identified in the proposal and used by the person to make its conclusions; and (4) that the person or affiliated purchasers will be purchasing or bidding during the restricted period (if that is in fact the case)? Would this approach also address concerns about the cost and effectiveness of independent third party verification and have the added benefit of full disclosure to investors? Would this approach present costs that do not arise under the current exceptions? What other representations should be included in the offering documents if this approach is taken? What benefits would this approach provide? What other concerns could this approach raise?
- Should the Commission permit the third party verification requirement to be deemed satisfied if one of the purchasers of the security is an unaffiliated regulated entity, such as a money market fund[80] or a broker-dealer that determines that the lesser haircut would apply to the security under the Net Capital Rule proposal above?[81] Such entities might be required to make their own determination regarding the creditworthiness of the security. Could this creditworthiness determination provide the benefits of an independent third party verifier (i.e., an independent assessment of

80 See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29592 (Mar. 3, 2011), 76 FR 12896 (Mar. 9, 2011).

81 See Section II.A.1, supra.

the security) without the cost of retaining such a verifier? What benefits would this approach provide? What other concerns could this approach raise? Would the timing of a distribution allow for this determination to be made prior to the beginning of the restricted period? Are there other entities that should be included under this alternative, and if so, which entities and why?

- Should persons subject to Rules 101 or 102 be able to rely on the determination of another person in the underwriting syndicate who is seeking to rely on the exception in connection with the same distribution or should all distribution participants, issuers, selling security holders, or affiliated purchasers be required to make their own determinations?
- The proposed criteria that, if satisfied, would except a specific security from Rules 101 and 102 of Regulation M, are designed to identify those characteristics of a security that would correlate with whether or not such a security was susceptible to manipulation during a time when it was distributed. Previously these criteria were considered to be met if the security had an investment grade rating. In proposing the criteria above, the Commission has focused on those trading-oriented characteristics of securities that the Commission believes (a) may be typical of securities with an investment grade rating, and (b) that are relevant to the question about manipulation. However, the Commission also notes that another common characteristic of securities with an investment grade rating is credit quality, and hence price or yield spread. Is credit quality alone a good determinant of whether or not a security is susceptible to manipulation under the conditions in which Rules 101 and 102 of Regulation M is concerned? Why or why not? If so, given the required removal of any reference to a

security's rating, how would credit quality be measured for the purposes of this rule? Would the price or yield of a security be a good proxy for credit quality? If so, should the Commission except nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities based on a specific premium to the London Interbank Offered Rate ("LIBOR") at pricing? Would the defined yield spread be difficult to determine for securities that are difficult to price? Would this approach lead to market participants adjusting the price of securities at issuance, delaying issuance, or engaging in other activities solely to obtain the exception? Is LIBOR an appropriate rate on which to base this test or would other rates be more appropriate? If such an approach was utilized, is at pricing the appropriate time at which to compare the rates? How should the spreads be calculated? Would nonconvertible preferred securities and asset-backed securities be able to continue to rely on the exception under this proposal? Would persons seeking to rely on the exception be able to determine this information before the beginning of the restricted period? What benefits would this approach provide? What other concerns could this approach raise? How difficult will it be to predict, ahead of issuance, what the new issue's yield spread to the reference rate will be at the time the issue is priced? What is the expected economic effect of difficulty in predicting the yield spread at the time of pricing? Would the number of issues brought to market be impacted?

- With regard to asset-backed securities, should the Commission, in place of or in addition to the proposed amendment, except asset-backed securities that would meet the requirements for shelf eligibility for such securities as recently proposed by the

Commission?[82] This would provide a bright line test for these securities but may alter the universe of asset-backed securities that could rely on the exceptions. What benefits would this approach provide? What other concerns could this approach raise? How would this approach address potential conflicts of interest involving the issuer, selling shareholder, distribution participant, or affiliated purchaser?

- Should the Commission except nonconvertible debt securities and nonconvertible preferred securities based on trading volume and outstanding relevant securities of the issuer? For example, the Commission could except nonconvertible debt securities where the issuer has at least $1 billion in outstanding debt and the trading volume of the outstanding debt securities of that issuer equaled or exceeded 100% turnover over a six month period, excluding trading by persons claiming the exception. This would have the benefit of establishing a bright line standard and is similar to the actively-traded securities exception found in Rule 101,[83] but may except a different universe of securities, be difficult to determine for securities that are hard to value, and would not be available to securities of new issuers. What benefits would this approach provide? What other concerns could this approach raise? Would such an exception tailored for nonconvertible preferred (referencing $1 billion outstanding equity and

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82 Asset-Backed Securities, Exchange Act Release No. 61858 (Apr. 7, 2010), 75 FR 23328 (May 3, 2010). This proposal would extend shelf eligibility to asset-backed securities where (1) a certification is filed at the time of each offering off of a shelf registration statement by the chief executive officer of the depositor that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service any payments due and payable on the securities as described in the prospectus; (2) the sponsor retains a specified amount of each tranche of the securitization, net of the sponsor's hedging; (3) a provision in the pooling and servicing agreement requires the party obligated to repurchase the assets for breach of representations and warranties to periodically furnish an opinion of an independent third party regarding whether the obligated party acted consistently with the terms of the pooling and servicing agreement with respect to any loans that the trustee put back to the obligated party for violation of representations and warranties and which were not repurchased; and (4) the issuer makes an undertaking to file Exchange Act reports so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets.

83 17 CFR 242.101(c)(1).

trading volume of the issuer's nonconvertible preferred securities) be appropriate? What other changes would need to be made in order to make the exception available to preferred securities generally? Are there different numerical thresholds that are better able to replicate the universe of currently excepted nonconvertible debt securities and preferred securities? If the Commission replaced the current criteria with a volume test, how much effort on the part of intermediaries would be required to demonstrate that a volume threshold was met? How difficult would it be for financial intermediaries to gather volume statistics? What would the range of associated costs be? If it was necessary under the volume test to exclude trading by persons subject to Rules 101 or 102, would that information be available to financial intermediaries? Are there other numerical tests of this type that would be more appropriate? How would this approach address potential conflicts of interest involving the issuer, selling shareholder, distribution participant, or affiliated purchaser?

- Should underwriters be required to keep records demonstrating their eligibility for the exception as modified by the proposal? Should underwriters be required to obtain records from the issuer or selling shareholder demonstrating eligibility for the exception as modified by the proposal and keep them? What records should be kept?
- Please comment generally on any relevant changes to the debt markets since Regulation M was adopted in 1996 and how these developments should affect the Commission's evaluation of the proposed amendments.

D. PROPOSED AMENDMENTS TO RULE 10b-10

Exchange Act Rule 10b-10,[84] the Commission's customer confirmation rule, generally requires broker-dealers effecting transactions for customers in securities, other than U.S. savings bonds or municipal securities,[85] to provide those customers with a written notification, at or before completion of the securities transaction, disclosing certain information about the terms of the transaction. Specifically, Rule 10b-10 requires the disclosure of the date, time, identity, and number of securities bought or sold; the capacity in which the broker-dealer acted (e.g., as agent or principal); yields on debt securities; and under specified circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties. By requiring these disclosures, the rule serves a basic customer protection function by conveying information that: (1) allows customers to verify the terms of their transactions; (2) alerts customers to potential conflicts of interest; (3) acts as a safeguard against fraud; and (4) allows customers a means of evaluating the costs of their transactions and the quality of the broker-dealer's execution.

Paragraph (a)(8) of Rule 10b-10, which the Commission adopted in 1994, requires a broker-dealer to inform the customer in the confirmation if a debt security, other than a government security, is unrated by an NRSRO.[86] As explained in the 1994 Adopting Release, paragraph (a)(8) was intended to alert customers to the potential need to obtain more information about a security from a broker-dealer;[87] it was not intended to suggest that an unrated security is

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84 17 CFR 240.10b-10.

85 Municipal securities are covered by Municipal Securities Rulemaking Board rule G-15, which applies to all municipal securities brokers and dealers.

86 See Confirmation of Transactions, Exchange Act Release No. 34962 (Nov. 10, 1994), 59 FR 59612 (Nov. 17, 1994) ("1994 Adopting Release").

87 Id. The Commission stated that "[i]n most cases, this disclosure should verify information that was disclosed to the investor prior to the transaction. If the customer was not previously informed on the security's unrated status, the confirmation may prompt a dialogue between the customer and the broker-dealer."

inherently riskier than a rated security. Rule 10b-10 does not require broker-dealers to disclose in customer confirmations the NRSRO rating for securities that are rated, although the Commission understands that some broker-dealers may do so voluntarily. The Commission has previously proposed, and re-proposed, the deletion of paragraph (a)(8) from Rule 10b-10.[88] The Commission's previous proposals to delete paragraph (a)(8) were prompted by concerns regarding the undue reliance on NRSRO ratings and confusion about the significance of those ratings. Section 939A of the Dodd-Frank Act requires the Commission to replace references to NRSRO ratings in its rules, where these act as a proxy for creditworthiness, with a different standard of creditworthiness. Because paragraph (a)(8) of Rule 10b-10 does not refer to NRSRO ratings as a means of determining creditworthiness, this provision does not come strictly within Section 939A's requirements. Nevertheless, the Commission preliminarily believes that to the extent that the provision is intended to focus investor attention on ratings issued by NRSROs, as distinct from other items of information, deleting it is consistent with the intent of the Dodd-Frank Act. Accordingly, the Commission is now re-proposing to delete paragraph (a)(8) from Rule 10b-10.[89]

However, the Commission wishes to consider the relative benefits of retaining this information in the customer confirmation against the benefits of removing it. The Commission notes that the current requirement to disclose the unrated status of a debt security provides investors with an item of factual information that is conveyed together with additional factual information about the terms of the transaction. The Commission also notes that if this provision

88 See, e.g., References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60790 (Oct. 5, 2009), 74 FR 52374 (Oct. 9, 2009); Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008).

89 Consistent with that change, the Commission is also proposing to redesignate paragraph (a)(9) of the rule, related to broker-dealers that are not members of the Securities Investor Protection Corporation ("SIPC"), as paragraph (a)(8).

were deleted from Rule 10b-10, broker-dealers would not be prohibited from continuing to provide this disclosure on a voluntary basis.[90] The Commission requests comment on the following:

- Would the investor protection function of Rule 10b-10 be, in any way, diminished by deleting paragraph (a)(8) from the rule? Are there are any alternative means of providing this information to customers?
- What types of securities would typically be unrated by an NRSRO? What types of issuers would typically not have their securities rated by an NRSRO?
- Could the disclosure that a security is unrated be removed from a customer confirmation without causing customer confusion? If so, given the historical use and investor expectations related to this disclosure, could it be removed without implying that a security is in fact rated? Should broker-dealers be required to alert customers that the unrated status of a security is no longer being disclosed? If so, for how long?
- The preliminary note to Rule 10b–10 provides: "This section requires broker-dealers to disclose specified information in writing to customers at or before completion of a transaction. The requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision." If paragraph (a)(8) were deleted, would the preliminary note to Rule 10b–10 affect a broker-dealer's decision to nonetheless continue to voluntarily disclose whether a security is unrated?

[90] Indeed, based on a limited review of customer confirmations, the Commission understands that in addition to disclosing the unrated status of a security, some broker-dealers may also voluntarily include the NRSRO ratings for rated securities.

- If paragraph (a)(8) were deleted, is there a disclosure that should be required in the confirmation on a transitional or permanent basis that would help prevent customer confusion? For example, should the Commission require broker-dealers, either permanently or temporarily for a transition period, to disclose that broker-dealers are no longer required to include on the confirmation the fact that a security is unrated? Should such a disclosure be made on the confirmation, the account statement, or in a separate document accompanying the confirmation or account statement? What are the costs associated with providing this disclosure on the confirmation, the account statement or in a separate document?
- If the requirement to disclose that a security is unrated were deleted from Rule 10b–10, would broker-dealers nevertheless feel compelled to include the disclosure in order to satisfy their sales practice obligations?
- Should the requirement to disclose that a security is unrated be replaced by a requirement to provide a general statement regarding the importance of considering an issuer's creditworthiness?
- If the requirement to disclose that a security is unrated were deleted from the rule, are there alternative external or objective measures of credit risk that could be substituted for ratings by an NRSRO? Is it practicable to replace it with a requirement to disclose specific information regarding an issuer's creditworthiness? If so, what specific information should the Commission consider including?

III. REQUESTS FOR COMMENT ON SECTION 939(e) OF DODD-FRANK

Section 939(e) of the Dodd-Frank Act[91] deleted Exchange Act references to credit ratings by NRSROs in Exchange Act Section 3(a)(41),[92] which defines the term "mortgage related security," and in Exchange Act Section 3(a)(53),[93] which defines the term "small business related security." The credit rating references in Sections 3(a)(41) and 3(a)(53) effectively exclude from the respective definitions securities that otherwise meet the definitions but are not rated by at least one NRSRO in the top two credit rating categories in the case of mortgage related securities or in the top four credit rating categories in the case of small business related securities. In place of the credit rating references, Congress added language stating that a mortgage related security and a small business related security will need to satisfy "standards of credit-worthiness as established by the Commission."[94] This replacement language will go into effect on July 21, 2012 (i.e., two years after the Dodd-Frank Act was signed into law).[95] Thus, before that time, the Commission will need to establish a new standard of creditworthiness for each Exchange Act definition. As is discussed below, the Commission is requesting comment on potential "standards of credit-worthiness" for purposes of Sections 3(a)(41) and 3(a)(53) as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

A. EXCHANGE ACT SECTION 3(a)(41)

Congress defined the term "mortgage related security" in Section 3(a)(41) as part of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA").[96] SMMEA was intended to encourage private sector participation in the secondary mortgage market by, among other

91 See Pub. L. No. 111-203 § 939(e).
92 15 U.S.C. 78a(3)(a)(41).
93 15 U.S.C. 78a(3)(a)(53).
94 See Pub. L. No. 111-203 § 939(e)(1) and (e)(2).
95 See Pub. L. No. 111-203 § 939(g).
96 Pub. L. No. 98-440, § 101, 98 Stat. 1689 (1984).

things, relaxing certain regulatory burdens that affected the ability of private-label issuers[97] to sell their mortgage-backed securities.[98] For example, SMMEA removed obstacles for privately sponsored mortgage-backed securities by, among other things, pre-empting certain state investment laws so that state regulated institutions might purchase privately sponsored mortgage-backed securities to the same extent as agency securities, granting authority for certain depository institutions to invest in these securities, and requiring states to exempt privately sponsored mortgage-backed securities from state registration to the same extent as agency securities, unless the state specifically deemed otherwise.[99] A security that qualifies as a mortgage related security, as defined in Section 3(a)(41), receives the benefits intended by SMMEA.[100]

Generally, Section 3(a)(41) defines the term "mortgage related security" as a "security that is rated in one of the two highest rating categories by at least one [NRSRO]," which (1) represents ownership of one or more promissory notes, or interests therein, which notes (a) are directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or mixed residential and commercial structure, or on a residential manufactured home or one or more parcels of real estate upon which is located one or more commercial structures and (b) were

97 Most mortgage-backed securities are issued by the Government National Mortgage Association ("Ginnie Mae"), a U.S. government agency, or the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), U.S. government-sponsored enterprises. Ginnie Mae, backed by the full faith and credit of the U.S. government, guarantees that investors receive timely payments. Fannie Mae and Freddie Mac also provide certain guarantees and, while not backed by the full faith and credit of the U.S. government, have special authority to borrow from the U.S. Treasury. Some private institutions, such as brokerage firms, banks, and homebuilders, also securitize mortgages, known as "private-label" mortgage securities.

98 The legislation was aimed at encouraging participation in the secondary mortgage market by investment banks, investment entities, mortgage bankers, private mortgage insurance companies, pension funds and other investors, depositary institutions and federal credit unions. See Kenneth G. Lore & Cameron L. Cowan, Mortgage-Backed Securities: Developments and Trends in the Secondary Market 2-39 (2001), at 1-14. See also Edward L. Pittman, Economic and Regulatory Developments Affecting Mortgage Related Securities, 64 Notre Dame L. Rev. 497, 499 (1989).

99 See Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management (May 1992).

100 See Pittman supra note 98, at 514.

originated by a savings or banking institution approved for insurance by the Secretary of the U.S. Department of Housing and Urban Development; or (2) is secured by one or more promissory notes, or interests therein, and provides for payments of principal in relation to payments, or reasonable projections of payments, on notes, or interests therein, meeting the requirements specified above.

When Congress adopted SMMEA, it used NRSRO ratings to specify mortgage related securities that qualify for benefits under the legislation. As reflected in Section 939(e) of the Dodd-Frank Act, Congress has chosen to no longer rely on credit ratings by NRSROs to make this distinction, and instead has instructed the Commission to establish a new standard of creditworthiness that does not rely on credit ratings by NRSROs. Before acting on this authority, the Commission invites interested persons to submit written comments on potential alternatives the Commission should consider for purposes of implementing Section 939(e) of the Dodd-Frank Act.

One potential alternative the Commission is considering is a new rule under the Exchange Act that would apply the "minimal amount of credit risk" standard the Commission is proposing with respect to the Net Capital Rule, as described above, to persons assessing whether a security is a mortgage related security within the meaning of Section 3(a)(41). The Commission preliminarily believes that the proposed minimal amount of credit risk standard for mortgage related securities would be consistent with the intended objective in Section 3(a)(41) of excluding from the definition mortgage related securities of lesser credit quality. The Commission further believes that the factors set forth above for facilitating determinations by broker-dealers as to whether a security satisfies the minimal amount of credit risk standard under the Net Capital Rule could facilitate determinations by others as to when mortgage related securities are subject to a minimal amount of credit risk under Section 3(a)(41). The Commission notes, however, that nonconvertible debt and preferred stock are currently required to be rated in one of the four highest credit rating categories by two NRSROs to qualify for reduced haircuts under the Net Capital Rule, and that a mortgage related security that qualifies as such under the current definition of that term in Section 3(a)(41) is required to satisfy a slightly more stringent level of credit quality (i.e., to be rated in one of the two highest rating categories of one NRSRO).

B. EXCHANGE ACT SECTION 3(a)(53)

Congress defined the term "small business related security" in Section 3(a)(53) as part of the Riegle Community Development and Regulatory Improvement Act of 1994 (the "CDRI").[101] Among other things, the CDRI removed limitations on purchases by national banks of certain small business-related securities. The stated intent of Congress in the CDRI was to increase small business access to capital by removing impediments in existing law to the securitizations of small business loans.[102] The CDRI built on the framework for securitizations established by SMMEA to create a similar framework for these securities with the goal of stimulating the flow of funds to small businesses.

Generally, Section 3(a)(53) defines the term "small business related security" as "a security that is rated in one of the four highest rating categories by at least one [NRSRO]" and either (i) represents an interest in promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution supervised and examined by federal or state authority or certain other regulated types of issuers,

101 Pub. L. No. 103-325, § 202, 108 Stat. 2198 (1994).

102 See Conference Report on the CDRI, Vol. 140 Cong. Record, pp. H6685, H6690 (Aug. 2, 1994). See also Remarks of Sen. Domenici, Vol. 140 Cong. Record, p. S11039, S11043-43 (Aug. 2, 1994) (discussing national banks' authority to purchase commercial mortgage related securities under conditions established by the Office of the Comptroller of the Currency).

or (ii) is secured by promissory notes or leases of personal property (with or without recourse to the issuer or lessee) and provides for payments of principal in relation to payments, or reasonable projections of payments, on notes or leases of the type described in the preceding clause.

When Congress adopted the term "small business related security" in the CDRI, it used NRSRO ratings to specify small business related securities that would qualify for benefits under the legislation. As reflected in Section 939(e) of the Dodd-Frank Act, Congress has chosen to no longer rely on credit ratings by NRSROs to make this distinction, and instead has instructed the Commission to establish a new standard of creditworthiness that does not rely on credit ratings of NRSROs. Before acting on this authority, the Commission invites interested persons to submit written comments on potential alternatives the Commission should consider for purposes of implementing Section 939(e) of the Dodd-Frank Act.

One potential alternative the Commission is considering is a new rule under the Exchange Act that would apply the "minimal amount of credit risk" standard the Commission is proposing with respect to the Net Capital Rule, as described above, to persons assessing whether a security is a small business related security within the meaning of Section 3(a)(53). The level of credit quality Congress intended for a small business related security to satisfy in Section 3(a)(53) to qualify for benefits under the CDRI is the same level of credit quality that nonconvertible debt and preferred stock must currently satisfy to qualify for reduced haircuts under the Net Capital Rule (i.e., NRSRO credit ratings in one of the four highest rating categories). The Commission preliminarily believes that the minimal amount of credit risk standard for small business related securities would be consistent with the intended objective of Congress in Section 3(a)(53) by excluding from the definition small business related securities of lesser credit quality. The Commission further preliminarily believes that the proposed factors set forth above for facilitating determinations by broker-dealers as to whether a security satisfies the minimal amount of credit risk standard under the Net Capital Rule could facilitate determinations by others as to when a small business related security is subject to a minimal amount of credit risk under Section 3(a)(53).

C. REQUESTS FOR COMMENT

The Commission requests comment on all aspects of how to implement Section 939(e) with respect to the definitions of mortgage related security and small business related security. In addition, the Commission requests comment on the following specific questions. In responding, commenters should distinguish between the two definitions to the extent that they believe that the two definitions should be treated differently for purposes of new rules.

- Is the minimal credit risk standard a practical and workable alternative for purposes of Section 3(a)(41) and Section 3(a)(53)? If not, what creditworthiness standard would be more appropriate?
- Who should be responsible for determining whether a security is creditworthy for these purposes? For example, is the sponsor, which is often involved in most, if not all, aspects of the securitization process, the most appropriate person to make this determination? Is the trustee a more appropriate person to make this determination based on the fiduciary relationship between the trustee and investors in the trust? Would an underwriter be an acceptable person to make the determination? Who else would be appropriate to make this determination?
- If the sponsor or another person makes the creditworthiness determination, could imposing disclosure obligations on that person with respect to its creditworthiness determination mitigate potential conflicts of interest?

- Should two or more persons be able to make the creditworthiness determination for the same security? If so, how could potential inconsistencies in that determination be resolved?
- If a sponsor or other person makes the creditworthiness determination, should that person be potentially liable to persons who relied on the determination? If so, what standard of liability should be applied?
- How often should creditworthiness determinations be made under Section 3(a)(41) or Section 3(a)(53) in order to determine if a security qualifies as a mortgage related security or small business related security?
- What objective measures could be used to determine whether securities qualify as mortgage related securities or small business related securities? Please explain what measures or creditworthiness standards the Commission should consider.
- Should the Commission adopt rules that are designed to allow regulators or other persons to examine or verify that creditworthiness determinations are consistent with the requirements of the rules? Should creditworthiness determinations be subject to regulatory review? Should the Commission require a person making the determination to create, maintain, and make available for examination certain records related to the determination?
- Should the Commission impose a more stringent creditworthiness standard than the minimal credit risk standard that is being proposed for purposes of the Net Capital Rule? If so, what standard should apply, and how could it be distinguished from the minimal credit risk standard?

- Would application of the minimal credit risk standard proposed for purposes of the Net Capital Rule result in securities of lesser credit quality qualifying as mortgage related securities or small business related securities as compared to securities that currently qualify as such under Section 3(a)(41) or Section 3(a)(53)? If so, please explain why this would be the case and provide examples.
- An alternative to credit ratings, if too rigid, could narrow the types of financial instruments that qualify under Section 3(a)(41) or Section 3(a)(53) and, if too flexible, could broaden the types of financial instruments that qualify under Section 3(a)(41) or Section 3(a)(53). In discussing potential alternatives to credit ratings, please analyze their potential impacts on competition and capital formation.

IV. PAPERWORK REDUCTION ACT

Certain provisions of the proposed amendments to the rules and form contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[103] The hours and costs associated with preparing and filing the disclosure, filing the form and schedules and retaining records required by these regulations constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The titles of the affected information forms are Rule 15c3-1 (OMB Control Number 3235-0200), Rule 15c3-3 (OMB Control Number 3235-0078), Rule 17a-4 (OMB Control Number 3235-0279) and Form X-17A-5, Financial and Operational Combined Uniform Single Report, Part IIB, OTC Derivatives Dealer (OMB Control Number 3235-0498); Rule 101 (OMB Control Number 3235-0464) and Rule 102 (OMB Control Number 3235-0467) of Regulation M; and Rule 10b–10 Confirmation of Transactions,'' (OMB Control Number

[103] 44 U.S.C. 3501 et seq.

3235–0444). For the reasons discussed below, the Commission does not believe the proposed amendments, if adopted, would result in a material or substantive revision to these collections of information.[104] The cost estimates contained in this section do not include any other possible costs or economic effects beyond the costs required to be calculated for PRA purposes.[105]

A. SUMMARY OF COLLECTION OF INFORMATION

As discussed above, the Commission is proposing amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, Rules 101 and 102 of Regulation M, and Rule 10b-10. These amendments, in part, are proposed to comply with Section 939A of the Dodd-Frank Act, which requires the Commission to replace references to credit ratings in all of its regulations with a standard of creditworthiness that the Commission deems appropriate.

The proposed amendments to the Net Capital Rule and Rule 17a-4 create a new standard of creditworthiness that will allow broker-dealers to establish their own policies and procedures to determine whether a security has only a minimal amount of credit risk. If a broker-dealer chooses to establish these policies and procedures it would create a new "collection of information" burden for those broker-dealers, as explained below. In addition, the proposed amendments to the Customer Protection Rule remove one method for verifying the status of a registered clearing agency or derivatives clearing organization under Note G to Exhibit A. Broker-dealers who may have to use a new method for verifying the status of a registered clearing agency or derivatives clearing organization may have a new "collection of information" within the meaning of the PRA.

104 5 CFR 1320.5(g).

105 See discussion below in Section V.C.2.

The proposed changes to Rules 101 and 102 of Regulation M would amend the exceptions for nonconvertible debt, nonconvertible preferred, and asset-backed securities in those rules. Under the proposed amendments, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to assess nonconvertible debt, nonconvertible preferred, and asset-backed securities to determine whether that security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads in order to rely on the exception. Further, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to obtain an independent third-party to verify their analysis under the proposal. Persons seeking to rely on these proposed revised exceptions would need to demonstrate compliance with the proposed revised exceptions. These requirements would impose a new "collection of information" within the meaning of the PRA.

The proposed amendment to Rule 10b-10 would eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. Although Section 939A of the Dodd-Frank Act requires the Commission to replace references to NRSRO ratings in its rules with a different standard of creditworthiness, the reference to NRSROs in Rule 10b-10 does not come strictly within Section 939A's requirements. The Commission believes, however, that deleting paragraph (a)(8) would make Rule 10b-10 consistent with how references to NRSROs and their ratings are being dealt with in other Commission rules pursuant to the requirements of the Dodd-Frank Act.

B. PROPOSED USE OF INFORMATION

The purpose of written policies and procedures, and the retention of these policies and procedures, is to ensure that examination staff, from either the Commission or an SRO, could review the policies and procedures to determine if the broker-dealer has an acceptable process for determining if a security has only a minimal amount of credit risk. In addition, written policies and procedures would give the staff consistent guidance on how to determine a minimal amount of credit risk.

As discussed above, the proposed changes to Rules 101 and 102 of Regulation M would amend the exceptions for nonconvertible debt, nonconvertible preferred, and asset-backed securities in those rules. Under the proposed amendments, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to assess nonconvertible debt, nonconvertible preferred, and asset-backed securities to determine whether that security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads in order to rely on the exception. Further, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to obtain an independent third-party to verify their analysis under the proposal. Persons seeking to rely on these proposed revised exceptions would need to demonstrate compliance with the proposed revised exceptions. The information collected under the proposal would be used to ensure that the nonconvertible debt, nonconvertible preferred, and asset-backed securities less likely to be subject to manipulation are excepted from Rules 101 and 102 of Regulation M, at the same time meeting the mandates of Section 939A of the Dodd-Frank Act.

The proposed amendment to Rule 10b-10 would eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. This proposed amendment would alter neither the general requirement that broker-dealers generate transaction confirmations and send those confirmations to customers, nor the potential use of information contained in confirmations by the Commission, self-regulatory organizations, and other securities regulatory authorities in the course of examinations, investigations and enforcement proceedings. Moreover, the proposed amendment is not expected to change the cost of generating and sending confirmations, and, the Commission believes that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, the Commission does not believe the proposed amendment would result in a material or substantive revision to these collections of information if adopted.

C. RESPONDENTS

The Commission estimates that the proposed collections of information would apply to the following number of respondents:

- Proposed amendments to Rule 15c3-1 and Rule 17a-4: 480 broker-dealers
- Proposed amendments to Appendices A, E, F, and G to Rule 15c3-1: 172 broker-dealers
- Proposed amendments to Exhibit A to Rule 15c3-3: 90 broker-dealers
- Proposed amendments to Form X-17A-5: 4 broker-dealers
- Proposed amendments to Regulation M: 2533 respondents. The Commission bases this estimate on the total number of respondents to Rules 101 (1588) and 102 (945).

- Proposed amendments to Rule 10b-10: 530 broker-dealers

The Commission generally requests comment on all aspects of these estimates for the number of broker-dealers. Commenters should provide specific data and analysis to support any comments they submit with respect to these estimates with respect to the number of respondents.

D. TOTAL INITIAL AND ANNUAL REPORTING AND RECORDKEEPING BURDEN

1. Rule 15c3-1 and Rule 17a-4

The proposed amendments to Rule 15c3-1 and Rule 17a-4 would modify broker-dealers' existing practices to impose additional recordkeeping burdens. The proposed amendments would replace NRSRO ratings-based criteria for evaluating creditworthiness with an option for a broker-dealer to apply new standards based on the broker-dealer's own evaluation of creditworthiness. A broker-dealer that did not want to make such an evaluation could instead take the higher haircuts. A broker-dealer that chooses to evaluate the creditworthiness of securities would have to explain how the haircuts used for net capital purposes meet the standards set forth in the proposed amendments. As such, the Commission believes that firms would be required to develop (if they have not already) criteria for assessing creditworthiness and apply those criteria to the securities included in the net capital calculation. The Commission preliminarily believes, however, that most firms that deduct haircuts for purposes of the Net Capital Rule when evaluating debt securities already have such an assessment process in place. The Commission preliminarily believes that broker-dealers that do not have such a system in place do not normally hold debt securities or, if they do, would choose to take the higher haircuts rather than create such a process. In addition, the expectation that the broker-dealer be able to explain how its haircuts meet the standards set forth in the proposed amendments would result in the creation and maintenance of records of those assessments.

The Commission preliminarily believes that all broker-dealers already have policies and procedures in place for evaluating the overall risk and liquidity levels of the securities they use for the purposes of the Net Capital Rule and that they retain these policies and procedures; however, the proposed amendments, which specifically address credit risk, could result in additional burdens for those broker-dealers that choose to use them. The proposed amendments would apply to the approximately 480 broker-dealers[106] that hold debt securities and take haircuts on these securities pursuant to paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2) and (c)(2)(vi)(H) of Rule 15c3-1. The Commission estimates that, on average, broker-dealers will spend 25 hours developing policies and procedures or revising their current policies and procedures for evaluating creditworthiness for the purposes of the Net Capital Rule, resulting in an aggregate initial burden of 12,000 hours.[107] This estimate is based on the Commission's belief that many of these broker-dealers already have their own criteria in place for evaluating creditworthiness and, therefore, most broker-dealers will only be revising their current policies and procedures for evaluating creditworthiness.

The Commission further estimates that, on average, each broker-dealer will spend an additional 10 hours a year reviewing and adjusting its own standards for evaluating creditworthiness, for a total of 4,800 annual hours across the industry.[108] This estimate does not reflect the time it will take for each broker-dealer to apply and implement its own standards for evaluating creditworthiness. This estimate reflects the Commission's belief that these broker-dealers already have their own criteria in place. The Commission also estimates that firms would use a controller to review these standards, both initially and on an annual basis. The

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106 This number was obtained by reviewing all FOCUS 2009 year-end submissions and then calculating how many firms report holding proprietary debt positions. See supra note 32.

107 480 broker-dealers x 25 hours = 12,000 hours.

108 480 broker-dealers x 10 hours = 4,800 hours.

Commission estimates the per-firm costs of the controller to be $10,825 initially and $4,330 on an annual basis, for an aggregate industry cost of $5,196,000 initially and $2,078,400 on an annual basis.[109] The Commission preliminarily believes that the proposed requirement to retain the policies and procedures for three years pursuant to Rule 17a-4 would result in de minimis costs. The three year preservation requirement in Rule 17a-4 will only be applicable once a broker-dealer changes its policies and procedures. In addition, all broker-dealers are currently required to comply with the three year preservation period in Rule 17a-4 for other records and should have procedures to satisfy such preservation requirements in place.

The proposed amendments to the appendices to Rule 15c3-1 include amendments to certain recordkeeping and disclosure requirements that are subject to the PRA. The proposed amendment to Appendix A to Rule 15c3-1 removes the NRSRO reference from the definition of "major market foreign currency." The Commission preliminarily believes that 158 broker-dealers trade in foreign currency and, therefore, would be affected by the proposed amendment.[110] However, it is not the intention of the Commission that the currencies meeting the definition of "major market foreign currency" should change. If, however, a broker-dealer wanted to request that a new currency meet the definition of "major market foreign currency" it would have to submit such a request to the Commission. The Commission preliminarily believes

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109 For the purposes of this analysis, the Commission is using salary data from the Securities Industry and Financial Markets Association ("SIFMA") Report on Management and Professional Earnings in the Securities Industry 2010, which provides base salary and bonus information for middle management and professional positions within the securities industry, as modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as SIFMA Report on Management and Professional Earnings in the Securities Industry 2010. The Commission believes that the reviews required by the proposed amendments would be performed by the controller at an average rate $433 per hour. Furthermore, the Commission believes that the review process will entail twenty-five hours initially and ten hours on an annual basis. $433 x 25 = $10,825 x 480 = $5,196,000; $433 x 10 = $4,330 x 480 = $2,078,400.

110 To arrive at this number, the Commission requested from the Options Clearing Corporation ("OCC") the number of broker-dealers that are authorized to clear foreign currency options. The Commission was given the number of 158. Although 158 broker-dealers are authorized to clear foreign currency options, the Commission does not know if all of these broker-dealers are actually clearing foreign currency options.

that submitting such a request to the Commission would take approximately ten hours for a total burden of 1,580 hours.[111] Additionally, the Commission believes that a broker-dealer would use an attorney to prepare this request, for a cost of $3,540 per firm and an aggregate industry cost of $559,320.[112]

The proposed amendments to Appendices E and F to Rule 15c3-1 and conforming amendments to Appendix G would remove the provisions permitting reliance on NRSRO ratings for the purposes of determining counterparty risk. As a result of these deletions, an entity that wished to use the approach set forth in these appendices to determine counterparty risks would be required, as part of its initial application to use the alternative approach or in an amendment, to request Commission approval to determine credit risk weights based on internal calculations and make and keep current a record of the basis for the credit risk weight of each counterparty.

The Commission does not believe that the removal of the option permitting reliance on NRSRO ratings would affect the small number of entities that currently elect to compute their net capital deductions pursuant to the alternative methods set forth in Appendix E or F. Although the collection of information obligations imposed by the proposed amendments are mandatory, applying for approval to use the alternative capital calculation is voluntary. To date, a total of six entities are using the methods set forth in Appendix E, while four are using the methods set forth in Appendix F. All of the approved firms already have developed models to calculate market and credit risk under the alternative net capital calculation methods set forth in

111 158 broker-dealers x 10 hours = 1,580.

112 The Commission believes that the reviews required by the proposed amendments would be performed by an attorney at an average rate of $354 per hour. Furthermore, the Commission believes that the review process will entail ten hours of initial work. 10 hours x $354 = $3,540 per firm. 158 broker-dealers x $3,540 = $599,320 aggregate industry cost. SIFMA Report on Management and Professional Earnings in the Securities Industry 2010.

the appendices as well as internal risk management control systems.[113] As such, each firm already employs the non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for determining counterparty credit risk under Appendices E and F. Since each entity already employs its own models to calculate market and credit risk and keeps current a record of the basis for the credit risk weight of each counterparty, the proposed amendments would not alter the paperwork burden currently imposed by Appendices E and F.

The Commission currently anticipates that three additional firms may apply for permission to use Appendix E and one additional firm may apply to use Appendix F. However, the Commission preliminarily believes that there should be no additional paperwork burden on these firms based on the proposed amendments. Any firm that applies to use Appendices E or F to Rule 15c3-1 must submit its internal models to the Commission for approval as part of that process. These models will calculate market risk and credit risk, as well as counterparty risk, which is not a change from the previous approval process for a firm that is applying to use Appendix E or Appendix F. In fact, the Commission believes that the only change to this process will be that the Commission will assign ratings scales to these models that can be used to determine counterparty risk when approving the models. Thus, the Commission does not believe the proposed amendments to Appendices E and F will alter the paperwork burden for such firms.

The instructions to Form X-17A-5 Part IIB currently include a summary of the credit risk calculation in paragraph (d) of Rule 15c3-1f. Paragraph (d) of Rule 15c3-1f is proposed to be amended to remove that part of the credit risk calculation that is summarized in Form X-17A-5 Part IIB. Accordingly, the Commission has proposed a conforming amendment to the form that

113 See, e.g., Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49830 (Jun. 8, 2004), 69 FR 34428 at 34456 (Jun. 21, 2004).

would remove the summary of the credit risk calculation. The summary in the instructions provides additional information for the benefit of the filer and is not related to the information reported on the forms. Accordingly, the Commission does not believe the proposed amendment would result in a substantive revision to these collections of information if adopted.

The Commission requests comment on all aspects of these proposed estimates. In addition, the Commission requests specific comment on the following items related to these estimates:

- Is the Commission correct in its hours estimates and belief that many broker-dealers already have their own policies and procedures in place for evaluating creditworthiness?
- Is the Commission correct in its belief that broker-dealers would engage outside counsel to review their internally generated standards for creditworthiness? If not, how would firms review such standards and what would be the effect of such differing approaches on our burden estimates?
- Is the Commission correct in its belief that new firms that apply to use the standards in Appendices E and F to Rule 15c3-1 will not have an extra burden as a result of the proposed amendments?
- Is the Commission correct in its estimation of the number of broker-dealers that trade foreign currency options?
- Is the Commission correct in its estimation on the number of hours it would take for a firm to make a submission to the Commission requesting that a currency be designated as a major market foreign currency?

- Is the Commission correct in its belief that a firm would engage outside counsel to make this submission? Or would a firm handle this internally?

2. Exhibit A to Rule 15c3-3

The proposed amendment to Note G to Exhibit A to Rule 15c3-3 would potentially modify broker-dealers' existing practices to impose additional recordkeeping burdens. Currently, Note G to Exhibit A to Rule 15c3-3 allows a broker-dealer to include, as a debit in the formula for determining its reserve requirements, the amount of customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization that meets one of four standards, including maintaining the highest investment grade rating from an NRSRO.[114] The proposed amendment would remove the standard of a registered clearing or derivatives organization that has the highest investment grade rating from an NRSRO as one of the four options a broker-dealer can look at prior to keeping customers' positions in security future products with such a firm. As such, the Commission believes that firms that previously relied on NRSRO ratings for the purposes of Note G would be required to use another method for assessing the creditworthiness of registered clearing or derivatives organizations. In addition, the expectation that the broker-dealer be able to explain that any such clearing or derivatives organizations it uses meet the standard set forth in the proposed amendment would result in the creation and maintenance of records of those assessments. The Commission estimates that approximately 90 firms would be required to comply with the

114 A broker-dealer may also include customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization (1) that maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits; (2) that maintains at least $3 billion in margin deposits; or (3) which does not meet any of the other criteria but which the Commission has agreed, upon a written request from the broker-dealer, that the broker-dealer may utilize. 17 CFR 240.15c3-3a, Note G, (b)(1)(ii)-(iv).

provisions of Note G.[115] In the final release adding Note G to Exhibit A to Rule 15c3-3,[116] the Commission estimated that under subparagraph (c) to Note G, each broker-dealer would spend approximately 0.25 hours to verify that the clearing organizations they used met the conditions of Note G. Using that same hours estimate, the Commission estimates an aggregate one-time total of 22.5 hours[117] for broker-dealers to verify the status of a registered clearing or derivatives organization under the proposed amendment. The Commission believes that the proposed amendment would impose an additional one-time burden for broker-dealers that need to change how they evaluate the creditworthiness of a registered clearing or derivatives organization. Given the additional options set forth in Note G, the Commission estimates this would result in the broker-dealer spending, on average, one hour determining whether a clearing organization meets the remaining requirements of Note G,[118] resulting in an aggregate initial burden of 90 hours.[119] The Commission also estimates that firms would use a senior operations manager to review these standards. The Commission estimates the one-time costs of senior operations manager to be $331 per-firm, resulting in an aggregate industry cost of $29,790.[120]

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115 The number 90 comes from reviewing the members of the OCC listed in the member directory on the OCC's website (http://www.optionsclearing.com/membership/member-information/). Of the list of 231 members, the Commission looked only at those who trade in single stock futures. Of the list of members that trade in single stock futures, the Commission deleted any members who had the exact same firm name but different firm numbers.

116 See Reserve Requirements for Margin Related to Security Futures Products, Exchange Act Release No. 34-50295 (Aug. 31, 2004), 69 FR 54182 at 54188 (Sep. 7, 2004).

117 0.25 x 90 = 22.5.

118 Currently the OCC is the only clearing agency registered with the Commission. The OCC maintains far more than $3 billion in margin deposits, which is another way for a broker-dealer to verify a registered clearing agency or derivatives clearing organization under Note G. Thus, the Commission believes that any broker-dealer who is currently using NRSRO ratings to verify a registered clearing agency or derivatives clearing organization will be able to quickly verify the registered clearing agency or derivatives clearing organization using a different method.

119 90 broker-dealers x 1 hour = 90 hours.

120 The Commission believes that the reviews required by the proposed amendments would be performed by a senior operations manager at an average rate of $331 per hour. Furthermore, the Commission believes that the review process will entail one hour of initial work. $331 x 1 = $331 x 90 = $29,790. SIFMA Report on Management and Professional Earnings in the Securities Industry 2010.

The Commission generally requests comment on all aspects of these proposed estimates. In addition, the Commission requests specific comment on the following items related to these estimates:

- Is the Commission correct in its estimate of the number of broker-dealers that would be affected by the proposed amendment to Note G?
- Is the Commission correct in its belief that broker-dealers would engage a senior operations manager to review their standards for verifying the status of a registered clearing agency or derivatives clearing organization? If not, how would firms review such standards and what would be the effect of such differing approaches on its burden estimates?

3. **Regulation M**

As discussed above, the proposed changes to Rules 101 and 102 of Regulation M would amend the exceptions for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities in those rules. Under the proposed amendments, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to assess nonconvertible debt, nonconvertible preferred, and asset-backed securities to determine whether that security reasonably is liquid relative to the market for that asset class, trade based on yield, and fungible with securities with similar yields in order to rely on the exception. Further, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to obtain an independent third-party to verify their analysis under the proposal. Persons seeking to rely on these proposed revised exceptions would need to demonstrate compliance with the proposed revised exceptions.

The Commission initially estimates that there are approximately 863 distributions of nonconvertible debt, nonconvertible preferred, and asset-backed securities, on average, annually that would be subject to the proposed revised exceptions. The Commission bases this estimate on the average number of offerings of investment grade nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities over the last three years.[121] The Commission believes that this is a reasonable estimate since it expects that the number of distributions eligible for the proposed revised exceptions should be similar to the number of distributions currently excepted under Rules 101(c)(2) and 102(d)(2).

The Commission initially estimates that the proposed revised exceptions would impose an average annual burden of 1 hour per distribution.[122] This accounts for the internal time to obtain the information necessary to comply with the proposed revised exceptions and conduct analysis based on this information. Further, the Commission initially estimates that the proposed revised exceptions would impose an outside cost burden to retain an independent third party to verify the analysis by the person seeking to rely on the proposed revised exceptions, resulting in an estimated average annual burden of $4,800[123] per distribution. Based on the total number of distributions estimated to be subject to the proposed revised exceptions (863), the Commission estimates that the total average annual burden is approximately 863 hours and $4.1 million.

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121 Rules 101 and 102 only apply to distributions, not all offerings of securities. As a result, the Commission discounted the actual average number of offerings of nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities over the last three years (1,151) by 25%.

122 We anticipate that the 1 hour would be spent by business analysts of the person seeking to rely on the proposed revised exceptions.

123 We estimate that an outside management consultant would spend 8 hours and charge $600 per hour to verify the analysis. The $600 per hour figure is from the 75th percentile figure for a management consultant from www.payscale.com, adjusted for an 1800-hour work-year and multiplied by a 5.35 factor which is normally used to include benefits but here is used as an approximation to offset the fact that New York salaries are typically higher than the rest of the country. The result is $596 per hour, which can be rounded to $600 per hour. We request comment on this estimate.

The collection of information would be necessary to obtain the benefit of the proposed revised exceptions. The proposed revised exceptions do not prescribe retention periods. All registered broker-dealers engaged in underwriting that would be subject to the proposed revised exceptions are currently required to retain records in accordance with Rules 17a-2 through 17a-4. The collection of information under the proposed revised exceptions would be provided to Commission and SRO examiners but would not be subject to public availability.

We specifically request comment on all aspects of these proposed estimates.

4. Rule 10b-10

The proposed amendment to Rule 10b-10 is not expected to change the cost of generating and sending confirmations, and, the Commission believes that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, the Commission does not believe the proposed amendment would result in any substantive change in a broker-dealer's record-keeping or reporting burdens.

5. Request for Comment

Pursuant to 44 U.S.C. 3306(c)(2)(B), the Commission requests comment on the proposed collections of information in order to: (1) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and (5) evaluate whether the proposed rule amendments would have any effects on any other collection of information not previously identified in this section.

Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, and refer to File No. S7-15-11. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the Federal Register; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-15-11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213.

V. ECONOMIC ANALYSIS

As discussed above, the Dodd-Frank Act requires that the Commission and other federal agencies replace references to credit ratings in all of its regulations with a standard of creditworthiness that the Commission deems appropriate. The proposed amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, Rules 101 and 102 of Regulation M, and Rule 10b-10 would accomplish this task by eliminating the reference to and requirement for the use of NRSRO ratings in these rules. The Commission recognizes that there are additional external costs associated with the adoption of the proposed amendments that are separate from the hour burdens discussed in the Paperwork Reduction Act. Thus, the Commission has identified certain costs and benefits of the proposed rule amendments and requests comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis.[124]

The Commission seeks comment and data on the value of the benefits identified. The Commission also seeks comments on the accuracy of its cost estimates in each section of this cost-benefit analysis, and requests those commenters to provide data, including identification of statistics relied on by commenters to reach conclusions on cost estimates. Finally, the Commission seeks estimates and views regarding these costs and benefits for particular types of market participants, as well as any other costs or benefits that may result from these proposed rule amendments.

Under Section 3(f) of the Exchange Act,[125] the Commission shall, when engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[126] requires the Commission to consider the competitive effects of any rules the Commission adopts under the Exchange Act. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission's preliminary view, as discussed in greater detail with respect to each proposed amendment below, is that any potential

124 SIFMA Report on Management and Professional Earnings in the Securities Industry 2010.

125 15 U.S.C. 78c(f).

126 15 U.S.C. 78w(a)(2).

burden on efficiency, competition, and capital formation resulting from the proposed rules would be consistent with the intent of Congress as expressed by the Dodd-Frank Act.

A. RULE 15c3-1 and RULE 17a-4

1. Benefits

The Commission anticipates that one of the primary benefits of the proposed amendments, if adopted, would be the benefit to broker-dealers of reducing their possible undue reliance on NRSRO ratings that could be caused by references to NRSROs in its rules. The rule amendments could encourage broker-dealers to examine more than a single source of information, such as a rating, when analyzing the creditworthiness of a financial instrument. Significantly, the Commission believes that eliminating the reliance on NRSRO ratings in its rules would remove any appearance that the Commission has placed its imprimatur on such ratings. The Commission, however, also recognizes that credit ratings may provide useful information to institutional and retail investors as part of the process of making an investment decision.

The Commission preliminarily believes that the proposed amendments to the Net Capital Rule and its appendices, as well as the conforming amendment to Rule 17a-4, could result in a better overall assessment of the risks associated with securities held by broker-dealers for the purposes of net capital calculations as well as of the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted. As the NRSROs themselves have stressed, the ratings they generate focus solely on credit risk, that is, the likelihood that an obligor or financial obligation will repay investors in accordance with the terms on which they made their investment.[127] Many broker-

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[127] See, e.g., Inside the Ratings: What Credit Ratings Mean, Fitch, Aug. 2007 ("Inside the Ratings"), p. 1; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United

dealers already conduct their own risk evaluation. However, for those broker-dealers that do not, developing their own means of evaluating risk – including, as would be required by the proposed amendments to the Net Capital Rule, an evaluation of the degree of liquidity – should allow them to better incorporate the overall levels of various categories of risk associated with the securities they hold for their net capital calculations and lead to a better understanding of the risks associated with those securities. The Commission believes that for those broker-dealers that do not currently have their own means of evaluating risk for purposes of the Net Capital Rule, the approach outlined in this release is the best option, outside of using NRSRO ratings, for a broker-dealer to evaluate the risks associated with those securities.

2. Costs

The Commission anticipates that broker-dealers could incur additional costs if the proposed amendments are adopted because of the costs associated with performing a more detailed and comprehensive analysis of the debt securities. These costs could include establishing, reviewing, and adjusting the various policies and procedures needed for a comprehensive analysis of the debt securities. There also could be costs associated with applying and implementing these adjusted procedures.

The Commission believes that the costs of compliance with the proposed amendments to the Net Capital Rule and its appendices, as well as the conforming amendment to Rule 17a-4, would be minimal for those entities that already employ their own criteria in determining credit risk for net capital purposes. Of the approximately 480 broker-dealers that hold proprietary debt positions, the Commission recognizes that the level of sophistication varies widely. The institutions with less sophisticated internal procedures for analyzing credit risk may incur costs

States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 3.

to establish and develop procedures that would be used to assess financial instruments for the purposes of determining whether the lower haircuts could appropriately be applied.

In the event the broker-dealer inaccurately evaluates the creditworthiness and liquidity of its positions, a potential cost could be that the broker-dealer is required to take a larger haircut on its proprietary positions, and, therefore, reserve additional capital. This could affect its ability to hold its positions or to add to its positions. In addition, the proposed rule could potentially affect the ability of issuers of commercial paper, nonconvertible debt, and preferred stock to raise capital if broker-dealers change their investment decisions for their proprietary accounts as a result of potential costs or other aspects of the proposed amendments.

Some broker-dealers may determine a security qualifies for a reduced haircut when it would not have qualified under the current NRSRO standard. This could have a potential impact on the firm's ability, if it experiences financial difficulties, to be in a position to meet all obligations to customers, investors, and other counterparties and generate resources to wind-down its operations in an orderly manner without the need of a formal proceeding, with attendant costs.

In addition, those broker-dealers whose internal evaluations differ from the ratings may have extra costs during examinations to prove to the regulators the accuracy of their internal evaluations. Those broker-dealers that do not have their own criteria for determining credit risk for net capital purposes will have larger start up costs than other broker-dealers. However, the Commission believes that firms that hold a small number of securities for net capital purposes may do an internal cost benefit analysis and decide to take the 15% haircut instead of creating an internal credit risk evaluation process if the costs of creating such an evaluation process are too high. To the extent that broker-dealers decide to take the 15% haircut instead of creating an internal credit risk evaluation process, it is possible that those broker-dealers may maintain more net capital than would be required by the Net Capital Rule.

For firms that use Appendix A to Rule 15c3-1, the Commission preliminarily believes there will be minimal costs associated with the proposed amendments. The proposed amendments to the definition of "major market foreign currency" will not change what foreign currencies meet the definition; it will only change the wording of the definition. Therefore, the Commission does not believe there will be any additional costs associated with the proposed amendments.

As for the firms that use Appendix E and F to Rule 15c3-1, these firms are already using internal ratings scales to determine credit risks for each counterparty. Any new firms that apply to use either Appendix E or Appendix F will not incur any additional costs as a result of the proposed amendments. Currently, firms that apply to use these appendices must have their internal models approved by the Commission prior to using their selected appendix. Although the Commission will have to assign a ratings scale to the output of the internal models during the approval process, the Commission does not believe this step will cause broker-dealers or OTC derivatives dealers who are applying to use these appendices to incur any additional costs. Furthermore, because these firms have traditionally used models, as opposed to NRSRO ratings, to compute capital charges, the Commission does not believe these firms will incur any additional costs by complying with the proposed amendments.

B. EXHIBIT A TO RULE 15c3-3

1. Benefits

The Commission believes that eliminating the reliance on NRSRO ratings in its rules would remove any appearance that the Commission has placed its imprimatur on such ratings.

The Commission preliminarily believes that the proposed amendments to Note G to Exhibit A to Rule 15c3-3 would serve to promote efficiency and capital formation. As noted above, the Commission believes that broker-dealers will develop their own means of evaluating the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted for purposes of Note G to Exhibit A to Rule 15c3-3. These broker-dealers would be better positioned to incorporate the overall levels of various categories of risk associated with those organizations into their assessments, creating a more efficient means of evaluating those organizations for the sake of the Customer Protection Rule, rather than simply relying on NRSRO credit ratings alone. As the NRSROs themselves have stressed, the ratings they generate focus solely on credit risk, that is, the likelihood that an obligor or financial obligation will repay investors in accordance with the terms on which they made their investment.[128] The Commission does not anticipate that the proposed amendments to Note G to Exhibit A to Rule 15c3-3 would have any impact on competition.

2. Costs

The Commission believes that the costs of compliance with Note G to Exhibit A to Rule 15c3-3 would be minimal because the amendment would simply eliminate one factor a broker-dealer can use to evaluate a clearing organization. The Commission believes that the removal of one of these four means of complying with section (b)(1) of Note G will not adversely affect the purpose of this section; namely to ensure that a broker or dealer has the margin related to security futures products on deposit only with qualified registered clearing agencies or derivatives clearing organizations. As stated in the Paperwork Reduction Act section, the

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[128] See, e.g., Inside the Ratings: What Credit Ratings Mean, Fitch, Aug. 2007 ("Inside the Ratings"), p. 1; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 3.

Commission anticipates that a broker-dealer will incur a one-time cost and an annual cost to verify that a clearing organization or derivatives clearing organization meets the requirements of Note G. If a broker-dealer is currently using a verification process other than the use of NRSRO ratings, that broker-dealer will not incur any one-time costs.

C. RULES 101 AND 102 OF REGULATION M

The purpose of the proposed revised exceptions from Rules 101 and 102 of Regulation M for nonconvertible debt, nonconvertible preferred, and asset-backed securities is to address Section 939A of the Dodd-Frank Act as well as place the emphasis of the exception on the trading aspects of the securities by those bringing it to market, ensuring that the exception is utilized in reference to securities that are less likely to be subject to manipulation.

The Commission preliminarily believes that the proposed amendments to Rules 101 and 102 of Regulation M are intended to promote capital formation. The proposed amendments should promote continued investor trust in the offering process by proposing an exception from Regulation M's Rule 101 and 102 prohibitions limited to those securities which are less vulnerable to manipulation. Such investor trust in our markets should promote continued capital formation. The Commission believes that the proposals should foster continued market integrity which should also translate into capital formation by only allowing for non-manipulative buying activity during distributions. Issuers of nonconvertible debt, nonconvertible preferred securities and asset-backed securities who fall within the proposed exceptions may be encouraged to engage in capital formation knowing that the proposed exceptions are available for their buying activity as well as the buying activity of distribution participants. For these reasons, the Commission preliminarily believes that the proposed exceptions will promote efficient capital formation and competition.

The Commission has considered the proposed amendments to Rules 101 and 102 of Regulation M in light of the standards cited in Section 23(a)(2) and believes preliminarily that, if adopted, they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. The proposals would apply equally to all distribution participants, issuers, selling shareholders, and affiliated purchasers. Thus, no person covered by Regulation M should be put at a competitive disadvantage and the proposal would not impose a significant burden on competition not necessary or appropriate in furtherance of the Act.

1. Benefits

The proposed revised exceptions should continue to promote investor trust in the offering process and the market as a whole by excepting only those nonconvertible debt, nonconvertible preferred, and asset-backed securities that are less vulnerable to manipulation. Market integrity would also continue to be promoted, which benefits the market and all participants.

2. Costs

The Commission expects the costs of the proposal to modify Rules 101 and 102 of Regulation M to be minimal to most persons subject to those rules. The Commission expects the number of instances in which the proposed revised exceptions would be triggered to be limited. The proposed revised exceptions would only be triggered when there is an offering of nonconvertible debt, nonconvertible preferred, or asset-backed securities that qualifies as a distribution under Regulation M where a distribution participant, issuer, selling shareholder, or affiliated purchaser bids for, purchases, or attempts to induce another person to bid for or purchase the covered security during the applicable restricted period. As there may be offerings of nonconvertible debt, nonconvertible preferred, and asset-backed securities that do not constitute a distribution for purposes of Regulation M, the prohibitions of Rules 101 and 102 of Regulation M would not be triggered and, thus, the need for reliance upon either the current or proposed revised exceptions would not be necessary. Additionally, even if a distribution of the nonconvertible debt, nonconvertible preferred, or asset-backed securities exists, a person subject to the prohibitions of Rules 101 or 102 of Regulation M could structure buying activity before or after the applicable restricted period so as not to incur any costs, even if minimal, associated with relying on the proposed revised exceptions.

When the proposed revised exceptions would be used, however, the Commission believes that there would be increased costs for distribution participants, issuers, selling shareholders, and affiliated purchasers under the proposed revised exceptions compared to the expected costs under the current exceptions in Rules 101(c)(2) and 102(d)(2). Distribution participants, issuers, selling shareholders, and affiliated purchasers would need to reasonably determine whether a security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads in order to rely on the exception. This determination would require the distribution participant, issuer, selling shareholder, or affiliated purchaser to train staff and devote manpower and other resources towards making this assessment when relying on the proposed revised exceptions. As detailed in the PRA section above, the Commission preliminarily estimates total annual ongoing internal costs of approximately $167,422 for distribution participants, issuers, selling shareholders, and affiliated purchasers seeking to rely on the exception.[129]

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[129] This figure was calculated as follows (1 business analyst hours x $194) = $194 per response x 863 responses = $167,422 total cost for all respondents. The Commission estimates that the average hourly rate for an intermediate business analyst in the securities industry is approximately $194 per hour. SIFMA Report on Management and Professional Earnings in the Securities Industry 2010.

Further, distribution participants, issuers, selling shareholders, and affiliated purchasers would need to obtain an independent third party to verify this initial assessment. This process would create new costs to be borne by distribution participants, issuers, selling shareholders, and affiliated purchasers when relying on the proposed revised exceptions to hire such a party and review this verification. Distribution participants, issuers, selling shareholders, and affiliated purchasers seeking an independent third party verification that the issue meets the criteria required to obtain the proposed exceptions may find that the price of the independent third party verification could potentially lead to other economic effects. These effects could include, for instance, the potential for the verifier to be liable for claims if the exception is disputed after it has been relied upon. While difficult to quantify, the Commission preliminarily estimates that it is possible for the verifier's potential liability to be a significant multiple of the compliance-hours-cost-estimate provided for PRA purposes, and will depend upon the perceived risk in asserting that the security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads. These are new costs not currently borne by distribution participants, issuers, selling shareholders, or their affiliated purchasers. If potential liability leads to increased costs in obtaining an independent third party, some persons who currently rely on the exception may determine that it is no longer cost effective to qualify for the exception. This may have the effect of limiting the instances in which the exception is utilized, which in turn may expand the scope of the restrictions of Rules 101 and 102 of Regulation M. Thus, the increase in costs resulting from the third party verification may, in effect, narrow the exceptions for those who currently rely on them.

The Commission also expects that there could be a small number of securities taken out of this exception as a result of the proposed change. Costs for issuers, selling shareholders, underwriters, brokers, dealers, any other distribution participants, or affiliated purchasers of any of these persons affected by this change would be more significant in that these persons may now be required to comply with Rule 101 or 102 of Regulation M where they did not have to before. As a result of this change, these affected parties and their affiliated purchasers would be prohibited from bidding for, purchasing, or attempting to induce any person to bid for or purchase the covered security during the restricted period. However, the Commission does not expect there to be a significant number of these persons. Further, these persons may be able to rely on a different exception from Rule 101 or 102 depending on the circumstances.

D. RULE 10b-10

1. Benefits

The proposed amendments to Rule 10b-10 eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. The other requirements of Rule 10b-10 would remain unchanged. Eliminating this requirement would avoid giving credit ratings an imprimatur that may inadvertently suggest to investors that an unrated security is inherently riskier than a rated security. Accordingly, the Commission anticipates that investors and the marketplace would benefit from the elimination of this requirement, in light of concerns about promoting over-reliance on securities ratings or creating confusion about the significance of those ratings. More generally, eliminating this requirement is consistent with the goal of promoting a dialogue between broker-dealers and their customers – prior to purchase – regarding the creditworthiness of issuers, and should help avoid promoting the use of credit ratings as an oversimplified shorthand that replaces a more complete discussion of credit quality issues.

2. Costs

The Commission does not expect the proposed amendment to result in any significant changes in the costs associated with Rule 10b-10. Broker-dealers will continue to generate transaction confirmations and send those confirmations to customers, and the proposed amendment, if adopted, would not be expected to change the cost of generating and sending confirmations. Moreover, the Commission believes that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems.

E. REQUEST FOR COMMENT ON ECONOMIC ANALYSIS

The Commission requests data to quantify the costs and the benefits above. The Commission seeks estimates of these costs and benefits, as well as any costs and benefits not already described, which could result from the adoption of the proposed amendments.

- The Commission seeks specific comments on the economic analysis outlined above with respect to Rule 15c3-1, its Appendices and Rule 17a-4. Are there any additional costs associated with these proposed amendments that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.
- The Commission seeks specific comments on the economic analysis outlined above with regard to Exhibit A to Rule 15c3-3. Are there any additional costs associated with the proposed amendment that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.

- The Commission seeks specific comments on the economic analysis outlined above with regard to the proposed revised exceptions to Rules 101 and 102 of Regulation M. What new costs would the proposed revised exceptions create for those seeking to rely on them? Are there any costs not already accounted for in this proposal created by the proposed revised exceptions?
- The Commission seeks specific comments on the economic analysis outlined above with regard to the Rule 10b-10. Are there any additional costs associated with this proposal that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.

VI. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"), the Commission must advise OMB as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of $100 million or more (either in the form of an increase or decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of the proposed rules and form on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VII. INITIAL REGULATORY FLEXIBILITY ANALYSIS

Section 3(a) of the Regulatory Flexibility Act of 1980[130] requires the Commission to undertake an initial regulatory flexibility analysis of the proposed rule on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.[131] Pursuant to Section 605(b) of the Regulatory Flexibility Act ("RFA"), the Commission hereby certifies that the proposed amendments to the rule, would not, if adopted, have a significant economic impact on a substantial number of small entities.

For purposes of Commission rulemaking in connection with the RFA, small entities include broker-dealers with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,[132] or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[133]

The proposed amendments to the securities haircut provisions in paragraphs (E), (F), and (H) of Rules 15c3-1(c)(2)(vi) and the conforming amendment to Rule 17a-4, if adopted, would not have a significant economic impact on a small number of entities. The Commission preliminarily believes that a broker-dealer with less than $500,000 in total capital holds very few positions and, in particular, a small number of debt securities. Thus, the Commission

130 5 U.S.C. 603(a).
131 5 U.S.C. 605(b).
132 See 17 CFR 240.17a-5(d).
133 See 17 CFR 240.0-10(c).

preliminarily believes that there are few small entities that will be subject to these new rules. In addition, if there are small broker-dealers that hold these debt positions, they are already required to examine the risk associated with their debt securities when taking haircuts on these securities. The proposed amendments could alter this process but it would not be a new process that the small broker-dealer would have to comply with. Accordingly, the rule would not have any significant economic impact on small entities because even if they have to change their current process, they are still required to examine the risk associated with their debt securities.

The proposed amendment to Appendix A to Rule 15c3-1 will not be a burden to small entities. Although the definition of major market foreign currency will change, the currencies that meet the definition will not change.

The proposed amendments to the Appendices E and F to Rule 15c3-1 (which include conforming amendments to Appendix G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB), if adopted, would not apply to small entities. Appendices E and G apply to broker-dealers that are part of a consolidated supervised entity and Appendix F and Form X-17A-5, Part IIB apply to OTC Derivatives Dealers that have applied to the Commission for authorization to compute capital charges as set forth in Appendix F in lieu of computing securities haircuts pursuant to Rule 15c3-1(c)(2)(vi). All of these brokers or dealers would be larger than the definition of a small broker dealer in Rule 0-10.

The proposed amendments to Exhibit A to Rule 15c3-3, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments to Exhibit A to Rule 15c3-3 would apply only to broker-dealers that clear and carry positions in security futures products in securities accounts for the benefit of customers. None of those broker-dealers affected by the rule is a small entity as defined in Rule 0-10.[134]

With respect to the amendments to Rules 101 and 102 of Regulation M, it is unlikely that any broker-dealer that is defined as a "small business" or "small organization" as defined in Rule 0-10 could be an underwriter or other distribution participant as they would not have sufficient capital to participate in underwriting activities. Small business or small organization for purposes of "issuers" or "person" other than an investment company is defined as a person who, on the last day of its most recent fiscal year, had total assets of $5 million or less. The Commission believes that none of the various persons that would be affected by this proposal would qualify as a small entity under this definition as it is unlikely that any issuer of that size had investment grade securities that could rely on the existing exception. Therefore, the Commission believes that these amendments would not impose a significant economic impact on a substantial number of small entities.

The Commission believes that the proposed amendment to Rule 10b-10 will not have a significant economic impact on a substantial number of small entities. While some broker-dealers that effect transactions in the debt securities currently subject to paragraph (a)(8) of that rule may be small entities, the proposed amendment should not result in any significant change to the cost of providing confirmations to customers in connection with those transactions.

The Commission encourages written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, Rules 101 and 102 of Regulation M, and Rule 10b-10,

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134 The main clearing organization, the OCC, requires its members to have total capital of $2.5 million, far above the $500,000 total capital threshold for a small business in Rule 0-10.

could have an effect on small entities that has not been considered. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

VIII. STATUTORY BASIS AND TEXT OF THE PROPOSED AMENDMENTS

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly, Sections 3(b), 15, 23(a), and 36 (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm), thereof, and Sections 939 and 939A of the Dodd-Frank Act, the Commission is proposing to amend §§ 240.10b-10, 240.15c3-1, 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g, 240.15c3-3a, 240.17a-4, 242.101, 242.102, and Form X-17A-5 Part IIB General Instructions under the Exchange Act.

List of Subjects in 17 CFR Parts 240, 242, and 249

Brokers, Fraud, Reporting and recordkeeping requirements, Securities

Text of Amendment

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

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

1. The authority citation for part 240 is amended by adding the following citations in numerical order and by adding "Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 USC 78o–7 note)" to the sub-authorities for §§ 240.10b-10, 240.15c3-1, and 240.17a-4.

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, 78n-1, 78o, 78o-4, 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.; 18 U.S.C. 1350 and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

Sections 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g are also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 USC 78o–7 note).

* * * * *

Section 240.15c3-3a is also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o–7 note).

* * * * *

2. Section 240.10b-10 is amended by removing paragraph (a)(8) and redesignating paragraph (a)(9) as paragraph (a)(8).

3. Section 240.15c3-1 is amended by revising paragraphs (c)(2)(vi)(E) introductory text, (c)(2)(vi)(F)(1) introductory text, (c)(2)(vi)(F)(2) introductory text, and (c)(2)(vi)(H). The revisions read as follows:

(c) * * *

(2) * * *

(vi) * * *

(E) Commercial paper, bankers acceptances and certificates of deposit. In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, and has only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, or in the case of any negotiable certificates of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(F)(1) Nonconvertible debt securities. In the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date, which are not traded flat or in default as to principal or interest and which have only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(2) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest, and which have only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, if such securities have maturity dates:

* * * * *

(H) In the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which has only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

4. Section 240.15c3-1a is amended by removing the phrase "whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and" and removing the sentence "For purposes of this section, the European Currency Unit (ECU) shall be deemed a major market foreign currency" from paragraph (b)(1)(i)(C).

5. Section 240.15c3-1e is amended by:

a. revising the introductory text in paragraph (c)(4)(vi);

b. removing paragraphs (c)(4)(vi)(A) through (c)(4)(iv)(D);

c. redesignating paragraphs (c)(4)(vi)(E), (F), and (G) as paragraphs (c)(4)(vi)(A), (B), and (C), respectively; and

d. revising newly redesignated paragraph (c)(4)(vi)(A).

The revisions read as follows:

§ 240.15c3–1e Deductions for market and credit risk for certain brokers or dealers (Appendix E to 17 CFR 240.15c3-1).

* * * * *

(c) * * *

(4)(vi) Credit risk weights of counterparties. A broker or dealer that computes its deductions for credit risk pursuant to this Appendix E shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the broker or dealer determines for the counterparty.

(A) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the broker's or dealer's internal credit risk management system, the Commission may approve the application. The broker or dealer must make and keep current a record of the basis for the credit rating of each counterparty;

* * * * *

6. Section 240.15c3-1f is amended by:

a. removing the phrase from paragraph (d)(2), "the counterparty factor. The counter party factors are:" and adding in its place "a counterparty factor of 20%, 50%, or 100% based on an internal credit rating the OTC derivatives dealer determines for the counterparty."; and

b. revising paragraphs (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4).

The revisions read as follows:

§ 240.15c3–1f Optional market and credit risk requirements for OTC derivatives dealers (Appendix F to 17 CFR 240.15c3-1).

* * * * *

(d) * * *

(3) * * *

(i) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt or commercial paper that would apply a 20% counterparty factor under (d)(2)(i) of this section, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(ii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 50% counterparty factor under (d)(2)(ii) of this section, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(iii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 100% counterparty factor under (d)(2)(iii) of this section, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital.

(4) Counterparties may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. Based on the strength of the OTC derivatives dealer's internal credit risk management system, the Commission may approve the application. The OTC derivatives dealer must make and keep current a record of the basis for the credit rating for each counterparty.

* * * * *

7. Section 240.15c3-1g(a)(3)(i)(F) is amended by removing the phrase "paragraphs (c)(4)(vi)(D) and (c)(4)(vi)(E)" and adding in its place "paragraph (c)(4)(vi)(A) and paragraph (c)(4)(vi)(B)".

8. Section 240.15c3-3a is amended by removing paragraph (b)(1)(i) of Note G and redesignating paragraphs (b)(1)(ii), (iii), and (iv) as paragraphs (b)(1)(i), (ii), and (iii), respectively.

9. Section 240.17a-4 is amended by:

a. Removing the phrase from paragraph (b)(12), "§240.15c3-1e(c)(4)(vi)(D) and (E)" and adding in its place "§240.15c3-1e(c)(4)(vi) "; and

b. Adding paragraph (b)(13).

The addition reads as follows:

§240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(b) * * *

(13) The written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness for the purpose of §240.15c3-1(c)(2)(vi)(E), (F)(1), (F)(2), and (H).

PART 242 – REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

10. The general authority citation for Part 242 is revised and the following citations are added in numerical order to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78 l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, 80a-37, unless otherwise noted.

* * * * *

Sections 242.101 and 242.102 are also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o–7 note).

* * * * *

11. Section 242.101 is amended by revising paragraph (c)(2) to read as follows:

§ 242.101 Activities by distribution participants.

* * * * *

(c) * * *

(2) Certain nonconvertible and asset-backed securities. Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are determined and demonstrated by the distribution participant or affiliated purchaser, and verified by an independent third party, utilizing reasonable factors of evaluation to:

(i) Be liquid relative to the market for that asset class;

(ii) Trade in relation to general market interest rates and yield spreads; and

(iii) Be relatively fungible with securities of similar characteristics and interest rate yield spreads; or

* * * * *

12. Section 242.102 is amended by revising paragraph (d)(2) to read as follows:

§ 242.102 Activities by issuers and selling security holders during a distribution.* * * * *

(d) * * *

(2) Certain nonconvertible and asset-backed securities. Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are determined and demonstrated by the issuer, selling security holder, or affiliated purchaser, and verified by an independent third party, utilizing reasonable factors of evaluation to:

(i) Be liquid relative to the market for that asset class;

(ii) Trade in relation to general market interest rates and yield spreads; and

(iii) Be relatively fungible with securities of similar characteristics and interest rate yield spreads; or

* * * * *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

13. The authority citation for Part 249 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 78a et seq., 7201 et. seq., 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Section 249.617 is also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 USC 78o–7 note).

* * * * *

14. Amend Form X-17A-5 Part IIB General Instructions (referenced in § 249.617) by:

a. removing Schedule IV: Internal Credit Rating Conversion; and

b. removing all but the first sentence in the section "Credit risk exposure" under the heading "Computation of Net Capital and Required Net Capital," and adding a second sentence that reads "The counter-party charge is computed using the credit risk weights assigned to the OTC derivatives dealer's internal calculations by the Commission under paragraph (d)(2) of Appendix F."

Note: The text of Form X-17A-5 Part IIB does not, and this amendment will not, appear in the Code of Federal Regulations.

* * * * *

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

April 27, 2011

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-64373 / April 29, 2011]

Order Making Fiscal Year 2012 Annual Adjustments to the Fee Rates Applicable under Section 31(c) of the Securities Exchange Act of 1934

I. Background

Section 31 of the Securities Exchange Act of 1934 ("Exchange Act") requires each national securities exchange and national securities association to pay transaction fees to the Commission.[1] Specifically, Section 31(b) requires each national securities exchange to pay to the Commission fees based on the aggregate dollar amount of sales of certain securities transacted on the exchange.[2] Section 31(c) requires each national securities association to pay to the Commission fees based on the aggregate dollar amount of sales of certain securities transacted by or through any member of the association other than on an exchange.[3]

The Investor and Capital Markets Fee Relief Act ("Fee Relief Act")[4] amended Section 31 of the Exchange Act to require the Commission to make annual adjustments to the fee rates applicable under this section for each of the fiscal years 2003 through 2011, and one final adjustment to fix the fee rates under these sections for fiscal year 2012 and beyond.[5]

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1 15 U.S.C. 78ee.

2 15 U.S.C. 78ee(b).

3 15 U.S.C. 78ee(c).

4 Pub. L. No. 107-123, 115 Stat. 2390 (2002).

5 See 15 U.S.C. 77f(b)(5), 77f(b)(6), 78m(e)(5), 78m(e)(6), 78n(g)(5), 78n(g)(6), 78ee(j)(1), and 78ee(j)(3). Section 31(j)(2) of the Exchange Act, 15 U.S.C. 78ee(j)(2), also requires the Commission, in specified circumstances, to make a mid-year adjustment to the fee rates under Sections 31(b) and (c) of the Exchange Act in fiscal years 2002 through 2011.

II. Fiscal Year 2012 Annual Adjustment to the Fee Rates Applicable under Sections 31(b) and (c) of the Exchange Act

Section 31(b) of the Exchange Act requires each national securities exchange to pay the Commission a fee at a rate, as adjusted by our order pursuant to Section 31(j)(1),[6] which currently is $19.20 per million of the aggregate dollar amount of sales of specified securities transacted on the exchange. Similarly, Section 31(c) requires each national securities association to pay the Commission a fee at the same adjusted rate on the aggregate dollar amount of sales of specified securities transacted by or through any member of the association otherwise than on an exchange. Section 31(j)(1) requires the Commission to make annual adjustments to the fee rates applicable under Sections 31(b) and (c) for each of the fiscal years 2003 through 2011.[7] Section 31(j)(3) requires the Commission to make one final adjustment for fiscal year 2012.[8]

Section 31(j)(3) specifies the method for determining the annual adjustment for fiscal year 2012. Specifically, the Commission must adjust the rates under Sections 31(b) and (c) to a "uniform adjusted rate that, when applied to the baseline estimate of the aggregate dollar amount of sales for fiscal year 2012, is reasonably likely to produce

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6 Order Making Fiscal Year 2011 Annual Adjustments to the Fee Rates Applicable under Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14(g), 31(b) and 31(c) of the Securities Exchange Act of 1934, Rel. No. 33-9122 (April 29, 2010), 75 FR 24757 (May 5, 2010).

7 The annual adjustments, as well as the mid-year adjustments required in specified circumstances under Section 31(j)(2) in fiscal years 2002 through 2011, are designed to adjust the fee rates in a given fiscal year so that, when applied to the aggregate dollar volume of sales for the fiscal year, they are reasonably likely to produce total fee collections under Section 31 equal to the "target offsetting collection amount" specified in Section 31(l)(1) for that fiscal year.

8 The final adjustment for fiscal year 2012 is designed to adjust the fee rate in 2012 and subsequent years so that, when applied to the aggregate dollar volume of sales for fiscal year 2012, it is reasonably like to produce total fee collections under Section 31 equal to the "target offsetting collection amount" for fiscal year 2011. Note, however, that Section 31 will be amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") effective on the later of October 1, 2011 or the date of enactment of an Act making a regular appropriation to the Commission for fiscal year 2012. Once the amendments become effective, the Commission will be required to make a new adjustment to the fee rates under Section 31 for fiscal year 2012 and subsequent fiscal years.

aggregate fee collections under [Section 31] in fiscal year 2012 (including assessments collected under [Section 31(d)]) that are equal to the target offsetting collection amount for fiscal year 2011."

Section 31(l)(1) specifies that the "target offsetting collection amount" for fiscal year 2011 is $1,321,000,000. Section 31(l)(2) defines the "baseline estimate of the aggregate dollar amount of sales" as "the baseline estimate of the aggregate dollar amount of sales of securities . . . to be transacted on each national securities exchange and by or through any member of each national securities association (otherwise than on a national securities exchange) during fiscal year 2012 as determined by the Commission, after consultation with the Congressional Budget Office and the Office of Management and Budget . . . ."

To make the baseline estimate of the aggregate dollar amount of sales for fiscal year 2012, the Commission is using the same methodology it developed in consultation with the CBO and OMB to project dollar volume for purposes of prior fee adjustments.[9] Using this methodology, the Commission calculates the baseline estimate of the aggregate dollar amount of sales for fiscal year 2012 to be $85,673,432,736,834. Based on this estimate, and an estimated collection of $27,453 in assessments on security futures transactions under Section 31(d) in fiscal year 2012, the uniform adjusted rate for fiscal year 2012 is $15.10 per million.[10]

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9 Appendix A explains how we determined the "baseline estimate of the aggregate dollar amount of sales" for fiscal year 2012 using our methodology, and then shows the purely arithmetical process of calculating the fiscal year 2012 annual adjustment based on that estimate. The appendix also includes the data used by the Commission in making its "baseline estimate of the aggregate dollar amount of sales" for fiscal year 2012.

10 The calculation of the adjusted fee rate assumes that the current fee rate of $19.20 per million will apply through October 31, 2012, due to the operation of the effective date provision contained in Section 31(j)(4)(A) of the Exchange Act.

III. Effective Dates of the Annual Adjustments

Section 31(j)(4)(A) of the Exchange Act provides that the fiscal year 2012 annual adjustments to the fee rates applicable under Sections 31(b) and (c) of the Exchange Act shall take effect on the later of October 1, 2011, or 30 days after the date on which a regular appropriation to the Commission for fiscal year 2012 is enacted.

It is important to note, however, that Section 991 of the Dodd-Frank Act amends Section 31 of the Exchange Act effective on the later of October 1, 2011 or the date of enactment of an Act making a regular appropriation to the Commission for fiscal year 2012. Once, the amendments become effective, new lapse in appropriations provisions will apply such that, if a regular appropriation to the Commission for fiscal year 2012 is not enacted on or before October 1, 2011, the new fee rates will not become effective until 60 days after the date such a regular appropriation is enacted.

Moreover, once the amendments to Section 31 become effective, the Commission will be required to make a new adjustment to the fee rates under Section 31 for fiscal year 2012. The new fee rates will be determined no later than 30 days after the date on which an Act making a regular appropriation to the Commission for fiscal year 2012 is enacted,[11] and they will become effective on the later of October 1, 2011 or 60 days after the date such a regular appropriation is enacted.

As a result of these amendments, if a regular appropriation to the Commission for fiscal year 2012 is not enacted on or before October 1, 2011, the fee rate adjustments

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[11] In the event an Act making a regular appropriation to the Commission for fiscal year 2012 is enacted more than 30 days prior to October 1, 2011, the Commission will need to defer making a new adjustment until October 1, 2011, because the amendments requiring the new adjustment will not be effective until that date.

under this order will never become effective. Rather the fee rate adjustments for fiscal year 2012 will be determined in accordance with the amendments to Section 31 made by the Dodd-Frank Act and will become effective 60 days after the date such a regular appropriation is enacted.

V. Conclusion

Accordingly, pursuant to Section 31 of the Exchange Act,[12]

IT IS HEREBY ORDERED that, if a regular appropriation to the Commission for fiscal year 2012 is enacted on or before October 1, 2011, the fee rates applicable under Sections 31(b) and (c) of the Exchange Act shall be $15.10 per million effective on the later of October 1, 2011, or 30 days after the date on which a regular appropriation to the Commission for fiscal year 2012 is enacted.

By the Commission.

Cathy H. Ahn
Deputy Secretary

12 15 U.S.C. 77f(b), 78m(e), 78n(g), and 78ee(j).

APPENDIX A

With the passage of the Investor and Capital Markets Relief Act, Congress has, among other things, established a target amount of monies to be collected from fees charged to investors based on the value of their transactions. This appendix provides the formula for determining such fees, which the Commission adjusts annually, and may adjust semi-annually.[13] In order to maximize the likelihood that the amount of monies targeted by Congress will be collected, the fee rate must be set to reflect projected dollar transaction volume on the securities exchanges and certain over-the-counter markets over the course of the year. As a percentage, the fee rate equals the ratio of the target amounts of monies to the projected dollar transaction volume.

For 2012, the Commission has estimated dollar transaction volume by projecting forward the trend established in the previous decade. More specifically, dollar transaction volume was forecasted for months subsequent to March 2011, the last month for which the Commission has data on transaction volume.

The following sections describe this process in detail.

A. Baseline estimate of the aggregate dollar amount of sales for fiscal year 2012.

First, calculate the average daily dollar amount of sales (ADS) for each month in the sample (March 2001 - March 2011). The monthly aggregate dollar amount of sales (exchange plus certain over-the-counter markets) is presented in column C of Table B.

Next, calculate the change in the natural logarithm of ADS from month to month. The average monthly percentage growth of ADS over the entire sample is 0.0074 and the standard deviation is 0.123. Assuming the monthly percentage change in ADS follows a random walk,

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13 Congress requires that the Commission make a mid-year adjustment to the fee rate if four months into the fiscal year it determines that its forecasts of aggregate dollar volume are reasonably likely to be off by 10% or more.

calculating the expected monthly percentage growth rate for the full sample is straightforward. The expected monthly percentage growth rate of ADS is 1.5 %.

Now, use the expected monthly percentage growth rate to forecast total dollar volume. For example, one can use the ADS for March 2011 ($282,580,668,926) to forecast ADS for April 2011 ($286,849,029,708 = $282,580,668,926 x 1.015).[14] Multiply by the number of trading days in April 2011 (20) to obtain a forecast of the total dollar volume for the month ($5,736,980,594,157). Repeat the method to generate forecasts for subsequent months.

The forecasts for total dollar volume are in column G of Table A. The following is a more formal (mathematical) description of the procedure:

1. Divide each month's total dollar volume (column C) by the number of trading days in that month (column B) to obtain the average daily dollar volume (ADS, column D).

2. For each month t, calculate the change in ADS from the previous month as $\Delta_t = \log(ADS_t / ADS_{t-1})$, where log (x) denotes the natural logarithm of x.

3. Calculate the mean and standard deviation of the series $\{\Delta_1, \Delta_2, \ldots, \Delta_{120}\}$. These are given by $\mu = 0.0074$ and $\sigma = 0.123$, respectively.

4. Assume that the natural logarithm of ADS follows a random walk, so that Δ_s and Δ_t are statistically independent for any two months s and t.

5. Under the assumption that Δ_t is normally distributed, the expected value of ADS_t / ADS_{t-1} is given by $\exp(\mu + \sigma^2/2)$, or on average $ADS_t = 1.015 \times ADS_{t-1}$.

[14] The value 1.015 has been rounded. All computations are done with the unrounded value.

6. For April 2011, this gives a forecast ADS of 1.015 × $282,580,668,926 = $286,849,029,708. Multiply this figure by the 20 trading days in April 2011 to obtain a total dollar volume forecast of $5,736,980,594,157.

7. For May 2011, multiply the April 2011 ADS forecast by 1.015 to obtain a forecast ADS of $291,181,863,773. Multiply this figure by the 21 trading days in May 2011 to obtain a total dollar volume forecast of $6,114,819,139,242.

8. Repeat this procedure for subsequent months.

B. Using the forecasts from A to calculate the new fee rate.

1. Use Table A to estimate fees collected for the period 10/1/11 through 10/31/11. The projected aggregate dollar amount of sales for this period is $6,590,802,501,369. Projected fee collections at the current fee rate of 0.0000192 are $126,543,408.

2. Estimate the amount of assessments on securities futures products collected during 10/1/11 and 9/30/12 to be $27,453 by projecting a 1.5% monthly increase from a base of $1,960 in March 2011.

3. Subtract the amounts $126,543,408 and $27,453 from the target offsetting collection amount set by Congress of $1,321,000,000 leaving $1,194,429,139 to be collected on dollar volume for the period 11/1/11 through 9/30/12.

4. Use Table A to estimate dollar volume for the period 11/1/11 through 9/30/12. The estimate is $79,082,630,235,466. Finally, compute the fee rate required to produce the additional $1,194,429,139 in revenue. This rate is $1,194,429,139 divided by $79,082,630,235,466 or 0.0000151036.

5. Round the result to the seventh decimal point, yielding a rate of .0000151 (or $15.10 per million).

Table A. Estimation of baseline of the aggregate dollar amount of sales.

Fee rate calculation.

a. Baseline estimate of the aggregate dollar amount of sales, 10/1/11 to 10/31/11 ($Millions)	6,590,803
b. Baseline estimate of the aggregate dollar amount of sales, 11/1/11 to 9/30/12 ($Millions)	79,082,630
c. Estimated collections in assessments on securities futures products in FY 2012 ($Millions)	0.027
d. Implied fee rate (($1,321,000,000 - 0.0000192*a - c) /b)	$15.10

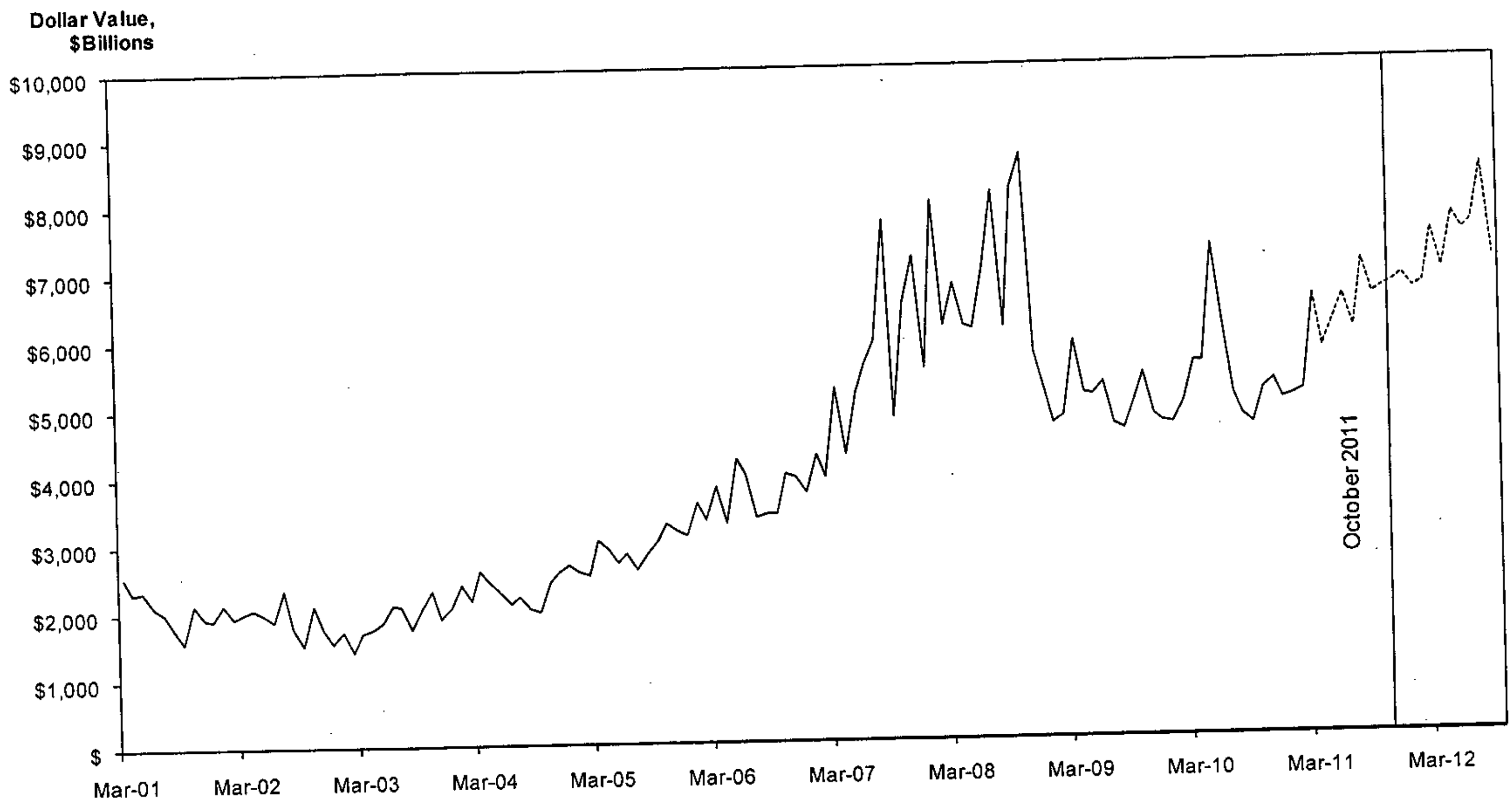
Data

(A) Month	(B) # of Trading Days in Month	(C) Aggregate Dollar Amount of Sales	(D) Average Daily Dollar Amount of Sales (ADS)	(E) Change in LN of ADS	(F) Forecast ADS	(G) Forecast Aggregate Dollar Amount of Sales
Mar-01	22	2,554,419,085,113	116,109,958,414	-		
Apr-01	20	2,324,349,507,745	116,217,475,387	0.001		
May-01	22	2,353,179,388,303	106,962,699,468	-0.083		
Jun-01	21	2,111,922,113,236	100,567,719,678	-0.062		
Jul-01	21	2,004,384,034,554	95,446,858,788	-0.052		
Aug-01	23	1,803,565,337,795	78,415,884,252	-0.197		
Sep-01	15	1,573,484,946,383	104,898,996,426	0.291		
Oct-01	23	2,147,238,873,044	93,358,211,871	-0.117		
Nov-01	21	1,939,427,217,518	92,353,677,025	-0.011		
Dec-01	20	1,921,098,738,113	96,054,936,906	0.039		
Jan-02	21	2,149,243,312,432	102,344,919,640	0.063		
Feb-02	19	1,928,830,595,585	101,517,399,768	-0.008		
Mar-02	20	2,002,216,374,514	100,110,818,726	-0.014		
Apr-02	22	2,062,101,866,506	93,731,903,023	-0.066		
May-02	22	1,985,859,756,557	90,266,352,571	-0.038		
Jun-02	20	1,882,185,380,609	94,109,269,030	0.042		
Jul-02	22	2,349,564,490,189	106,798,385,918	0.126		
Aug-02	22	1,793,429,904,079	81,519,541,095	-0.270		
Sep-02	20	1,518,944,367,204	75,947,218,360	-0.071		
Oct-02	23	2,127,874,947,972	92,516,302,086	0.197		
Nov-02	20	1,780,816,458,122	89,040,822,906	-0.038		
Dec-02	21	1,561,092,215,646	74,337,724,555	-0.180		
Jan-03	21	1,723,698,830,414	82,080,896,686	0.099		
Feb-03	19	1,411,722,405,357	74,301,179,229	-0.100		
Mar-03	21	1,699,581,267,718	80,932,441,320	0.085		
Apr-03	21	1,759,751,025,279	83,797,667,870	0.035		
May-03	21	1,871,390,985,678	89,113,856,461	0.062		
Jun-03	21	2,122,225,077,345	101,058,337,016	0.126		
Jul-03	22	2,100,812,973,956	95,491,498,816	-0.057		
Aug-03	21	1,766,527,686,224	84,120,366,011	-0.127		
Sep-03	21	2,063,584,421,939	98,265,924,854	0.155		
Oct-03	23	2,331,850,083,022	101,384,786,218	0.031		
Nov-03	19	1,903,726,129,859	100,196,112,098	-0.012		
Dec-03	22	2,066,530,151,383	93,933,188,699	-0.065		
Jan-04	20	2,390,942,905,678	119,547,145,284	0.241		
Feb-04	19	2,177,765,594,701	114,619,241,826	-0.042		
Mar-04	23	2,613,808,754,550	113,643,858,893	-0.009		
Apr-04	21	2,418,663,760,191	115,174,464,771	0.013		
May-04	20	2,259,243,404,459	112,962,170,223	-0.019		
Jun-04	21	2,112,826,072,876	100,610,765,375	-0.116		
Jul-04	21	2,209,808,376,565	105,228,970,313	0.045		
Aug-04	22	2,033,343,354,640	92,424,697,938	-0.130		
Sep-04	21	1,993,803,487,749	94,943,023,226	0.027		
Oct-04	21	2,414,599,088,108	114,980,908,958	0.191		
Nov-04	21	2,577,513,374,160	122,738,732,103	0.065		
Dec-04	22	2,673,532,981,863	121,524,226,448	-0.010		
Jan-05	20	2,581,847,200,448	129,092,360,022	0.060		
Feb-05	19	2,532,202,408,589	133,273,810,978	0.032		
Mar-05	22	3,030,474,897,226	137,748,858,965	0.033		
Apr-05	21	2,906,386,944,434	138,399,378,306	0.005		
May-05	21	2,697,414,503,460	128,448,309,689	-0.075		

Jun-05	22	2,825,962,273,624	128,452,830,619	0.000		
Jul-05	20	2,604,021,263,875	130,201,063,194	0.014		
Aug-05	23	2,846,115,585,965	123,744,155,912	-0.051		
Sep-05	21	3,009,640,645,370	143,316,221,208	0.147		
Oct-05	21	3,279,847,331,057	156,183,206,241	0.086		
Nov-05	21	3,163,453,821,548	150,640,658,169	-0.036		
Dec-05	21	3,090,212,715,561	147,152,986,455	-0.023		
Jan-06	20	3,573,372,724,766	178,668,636,238	0.194		
Feb-06	19	3,314,259,849,456	174,434,728,919	-0.024		
Mar-06	23	3,807,974,821,564	165,564,122,677	-0.052		
Apr-06	19	3,257,478,138,851	171,446,217,834	0.035		
May-06	22	4,206,447,844,451	191,202,174,748	0.109		
Jun-06	22	3,995,113,357,316	181,596,061,696	-0.052		
Jul-06	20	3,339,658,009,357	166,982,900,468	-0.084		
Aug-06	23	3,410,187,280,845	148,269,012,211	-0.119		
Sep-06	20	3,407,409,863,673	170,370,493,184	0.139		
Oct-06	22	3,980,070,216,912	180,912,282,587	0.060		
Nov-06	21	3,933,474,986,969	187,308,332,713	0.035		
Dec-06	20	3,715,146,848,695	185,757,342,435	-0.008		
Jan-07	20	4,263,986,570,973	213,199,328,549	0.138		
Feb-07	19	3,946,799,860,532	207,726,308,449	-0.026		
Mar-07	22	5,245,051,744,090	238,411,442,913	0.138		
Apr-07	20	4,274,665,072,437	213,733,253,622	-0.109		
May-07	22	5,172,568,357,522	235,116,743,524	0.095		
Jun-07	21	5,586,337,010,802	266,016,048,133	0.123		
Jul-07	21	5,938,330,480,139	282,777,641,911	0.061		
Aug-07	23	7,713,644,229,032	335,375,836,045	0.171		
Sep-07	19	4,805,676,596,099	252,930,347,163	-0.282		
Oct-07	23	6,499,651,716,225	282,593,552,879	0.111		
Nov-07	21	7,176,290,763,989	341,728,131,619	0.190		
Dec-07	20	5,512,903,594,564	275,645,179,728	-0.215		
Jan-08	21	7,997,242,071,529	380,821,051,025	0.323		
Feb-08	20	6,139,080,448,887	306,954,022,444	-0.216		
Mar-08	20	6,767,852,332,381	338,392,616,619	0.098		
Apr-08	22	6,150,017,772,735	279,546,262,397	-0.191		
May-08	21	6,080,169,766,807	289,531,893,657	0.035		
Jun-08	21	6,962,199,302,412	331,533,300,115	0.135		
Jul-08	22	8,104,256,787,805	368,375,308,537	0.105		
Aug-08	21	6,106,057,711,009	290,764,652,905	-0.237		
Sep-08	21	8,156,991,919,103	388,428,186,624	0.290		
Oct-08	23	8,644,538,213,244	375,849,487,532	-0.033		
Nov-08	19	5,727,998,341,833	301,473,596,939	-0.221		
Dec-08	22	5,176,041,317,640	235,274,605,347	-0.248		
Jan-09	20	4,670,249,433,806	233,512,471,690	-0.008		
Feb-09	19	4,771,470,184,048	251,130,009,687	0.073		
Mar-09	22	5,885,594,284,780	267,527,012,945	0.063		
Apr-09	21	5,123,665,205,517	243,984,057,406	-0.092		
May-09	20	5,086,717,129,965	254,335,856,498	0.042		
Jun-09	22	5,271,742,782,609	239,624,671,937	-0.060		
Jul-09	22	4,659,599,245,583	211,799,965,708	-0.123		
Aug-09	21	4,582,102,295,783	218,195,347,418	0.030		
Sep-09	21	4,929,155,364,888	234,721,684,042	0.073		
Oct-09	22	5,410,025,301,030	245,910,240,956	0.047		
Nov-09	20	4,770,928,103,032	238,546,405,152	-0.030		
Dec-09	22	4,688,555,303,171	213,116,150,144	-0.113		
Jan-10	19	4,661,793,708,648	245,357,563,613	0.141		
Feb-10	19	4,969,848,578,023	261,570,977,791	0.064		

Mar-10	23	5,563,529,823,621	241,892,601,027	-0.078		
Apr-10	21	5,546,445,874,917	264,116,470,234	0.088		
May-10	20	7,260,430,376,294	363,021,518,815	0.318		
Jun-10	22	6,124,776,349,285	278,398,924,967	-0.265		
Jul-10	21	5,058,242,097,334	240,868,671,302	-0.145		
Aug-10	22	4,765,828,005,840	216,628,545,720	-0.106		
Sep-10	21	4,640,722,344,586	220,986,778,314	0.020		
Oct-10	21	5,138,411,712,272	244,686,272,013	0.102		
Nov-10	21	5,279,700,881,901	251,414,327,710	0.027		
Dec-10	22	4,998,574,681,208	227,207,940,055	-0.101		
Jan-11	20	5,043,391,121,345	252,169,556,067	0.104		
Feb-11	19	5,114,631,590,581	269,191,136,346	0.065		
Mar-11	23	6,499,355,385,307	282,580,668,926	0.049	286,849,029,708	5,736,980,594,157
Apr-11	20				291,181,863,773	6,114,819,139,242
May-11	21				295,580,144,987	6,502,763,189,725
Jun-11	22				300,044,861,925	6,000,897,238,491
Jul-11	20				304,577,018,091	7,005,271,416,102
Aug-11	23				309,177,632,153	6,492,730,275,209
Sep-11	21				313,847,738,160	6,590,802,501,369
Oct-11	21				318,588,385,785	6,690,356,101,486
Nov-11	21				323,400,640,553	6,791,413,451,608
Dec-11	21				328,285,584,084	6,565,711,681,687
Jan-12	20				333,244,314,338	6,664,886,286,769
Feb-12	20				338,277,945,858	7,442,114,808,879
Mar-12	22				343,387,610,022	6,867,752,200,434
Apr-12	20				348,574,455,297	7,668,638,016,529
May-12	22				353,839,647,499	7,430,632,597,469
Jun-12	21				359,184,370,052	7,542,871,771,086
Jul-12	21				364,609,824,257	8,386,025,957,901
Aug-12	23				370,117,229,559	7,032,227,361,619
Sep-12	19					

Figure A.
Aggregate Dollar Amount of Sales Subject to Exchange Act Sections 31(b) and 31(c)[1]
Methodology Developed in Consultation With OMB and CBO
(Dashed Line Indicates Forecast Values)



[1]Forecasted line is not smooth because the number of trading days varies by month.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64368 / April 29, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14359

In the Matter of **MAGNUM D'OR RESOURCES, INC.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

RESPONDENT

1. Magnum d'Or Resources, Inc. ("Magnum" or "Respondent") is a Nevada corporation headquartered in Hudson, Colorado with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. Magnum's common stock (ticker "MDOR") is quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group, Inc.

DELINQUENT FILINGS

2. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers with classes of securities registered pursuant to Section 12 of the Exchange Act to file with

the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports and Rule 13a-13 requires issuers to file quarterly reports.

3. Magnum filed its last Form 10-K for the year ended September 30, 2009 on January 13, 2010, and its last Form 10-Q for the three months ended December 31, 2009 on February 16, 2010. Since then, Magnum has not submitted its required periodic filings.

4. As discussed above, Magnum is delinquent in its periodic filings with the Commission. The following periodic filings are delinquent.

Form	Period Ended	Due on or about
10-Q	March 31, 2010	May 15, 2010
10-Q	June 30, 2010	August 14, 2010
10-K	September 30, 2010	December 29, 2010
10-Q	December 31, 2010	February 14, 2011

5. As a result of the conduct described above, Magnum has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

III.

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

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford 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 registered pursuant to Section 12 of the Exchange Act.

IV.

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

IT IS FURTHER ORDERED that 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 of the Commission's Rules of Practice [17 C.F.R. § 201.220].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against 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 mail.

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

April 29, 2011

IN THE MATTER OF
Magnum d'Or Resources, Inc.
File No. 500-1

ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Magnum d'Or Resources, Inc. ("Magnum") because of questions regarding the accuracy of assertions by Magnum in its website and in press releases to investors concerning, among other things: (1) the company's current financial condition; and (2) the company's current operations.

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 in the above-listed company is suspended for the period from 9:30 a.m. EDT on April 29, 2011, through 11:59 p.m. EDT, on May 12, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 229 and 240

[RELEASE NOS. 33-9203; 34-64366; FILE NO. S7-13-11]

RIN 3235-AK95

LISTING STANDARDS FOR COMPENSATION COMMITTEES

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; extension of comment period.

SUMMARY: The Securities and Exchange Commission is extending the comment period for a release proposing a new rule and rule amendments to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which added Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act"). [Release No. 33-9199; 76 FR 18966 (April 6, 2011)]. The original comment period for Release 33-9199 is scheduled to end on April 29, 2011. The Commission is extending the time period in which to provide the Commission with comments on that release to May 19, 2011. This action will allow interested persons additional time to analyze the issues and prepare their comments.

DATES: Comments should be received on or before May 19, 2011.

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; or
- Use the Federal Rulemaking ePortal (http://www.regulations.gov). Follow the instructions for submitting comments.

other things, require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent," as defined in the listing standards of the exchanges adopted in accordance with the proposed rule. In addition, Section 10C(c)(2) of the Exchange Act requires the Commission to adopt new disclosure rules concerning the use of compensation consultants and conflicts of interest. The Commission approved the proposal at an open meeting on March 30, 2011, and the release was posted on the Commission's website on that date. The release was published in the Federal Register on April 6, 2011.

The Commission originally requested that comments on the release be received by April 29, 2011. A commentator has asked that the Commission extend the period of time for public comment on the proposing release.[1] After considering the request and the issues presented by the release, the Commission believes that providing the public additional time to consider the matters addressed by the release and to submit responses to the release would benefit the Commission in its consideration of final rules. Therefore, the Commission is extending the comment period for Release No. 33-9199, "Listing Standards for Compensation Committees," to May 19, 2011.

By the Commission.

Cathy H. Ahn
Deputy Secretary

April 29, 2011

[1] See letter from Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce (Apr. 15, 2011). Comments are available on the Commission's Internet website at http://www.sec.gov/comments/s7-13-11/s71311.shtml.

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038-AD46

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 33-9204; 34-64372; File No. S7-16-11

RIN 3235-AL14

Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

AGENCIES: Commodity Futures Trading Commission; Securities and Exchange Commission.

ACTION: Joint proposed rules; proposed interpretations.

SUMMARY: In accordance with section 712(a)(8), section 712(d)(1), sections 712(d)(2)(B) and (C), sections 721(b) and (c), and section 761(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, "Commissions"), in consultation with the Board of Governors of the Federal Reserve System ("Board"), are jointly issuing proposed rules and proposed interpretive guidance under the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") to further define the terms "swap," "security-based swap," and "security-based swap agreement" (collectively, "Product Definitions"), regarding "mixed swaps," and governing books and records with respect to "security-based swap agreements."

52 of 52

DATES: Comments should be received on or before [INSERT DATE 60 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Comments may be submitted, identified by File No. S7-16-11, by any of the following methods:

CFTC:

- Agency website, via its Comments Online process: http://comments.cftc.gov. Follow the instructions for submitting comments through the website.

- Mail: David A. Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

- Hand Delivery/Courier: Same as mail above.

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

Please submit your comments using only one method. "Product Definitions" must be in the subject field of responses submitted via e-mail, and clearly indicated on written submissions. All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the CFTC to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in section 145.9 of the CFTC's regulations.[1]

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from www.cftc.gov that it may deem to be inappropriate for publication, including obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

SEC:

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 S7-16-11 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 S7-16-11. This file number should be included on the subject line if e-mail is used. To help us process and review your

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[1] 17 CFR 145.9.

comments more efficiently, please use only one method. The SEC will post all comments on the SEC's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the SEC'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; the SEC does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: CFTC: Julian E. Hammar, Assistant General Counsel, at 202-418-5118, jhammar@cftc.gov, Mark Fajfar, Assistant General Counsel, at 202-418-6636, mfajfar@cftc.gov, or David E. Aron, Counsel, at 202-418-6621, daron@cftc.gov, Office of General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581; SEC: Matthew A. Daigler, Senior Special Counsel, at 202-551-5578, Cristie L. March, Attorney-Adviser, at 202-551-5574, or Leah M. Drennan, Attorney-Adviser, at 202-551-5507, Division of Trading and Markets, or Michael J. Reedich, Special Counsel, or Tamara Brightwell, Senior Special Counsel to the Director, at 202-551-3500, Division of Corporation Finance, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commissions jointly are proposing new rules and interpretive guidance under the CEA and the Exchange Act relating to the Product Definitions, mixed swaps, and security-based swap agreements.

TABLE OF CONTENTS

I. Background.

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[2] Title VII of the Dodd-Frank Act[3] ("Title VII") established a comprehensive new regulatory framework for swaps and security-based swaps. The legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: i) providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; ii) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; iii) creating rigorous recordkeeping and real-time reporting regimes; and iv) enhancing the rulemaking and enforcement authorities of the Commissions with respect to, among others, all registered entities and intermediaries subject to the Commissions' oversight.

Section 712(d)(1) of the Dodd-Frank Act provides that the Commissions, in consultation with the Board, shall jointly further define the terms "swap," "security-based swap," and "security-based swap agreement" ("SBSA").[4] Section 712(a)(8) of the Dodd-

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2 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act is available at http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.

3 Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

4 In addition, section 719(d)(1)(A) of the Dodd-Frank Act requires the Commissions to conduct a joint study, within 15 months of enactment, to determine whether stable value contracts, as defined in section 719(d)(2) of the Dodd-Frank Act, are encompassed by the swap definition. If the Commissions determine that stable value contracts are encompassed by the swap definition, section 719(d)(1)(B) of the Dodd-Frank Act requires the Commissions jointly to determine whether an exemption for those contracts from the swap definition is appropriate and in the public interest. Section 719(d)(1)(B) also requires the Commissions to issue regulations implementing the determinations made under the required study. Until the effective date of such regulations, the requirements under Title VII do not apply to stable value contracts, and stable value

Frank Act provides further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII. In addition, sections 721(b) and 761(b) of the Dodd-Frank Act provide that the Commissions may adopt rules to further define terms included in subtitles A and B, respectively, of Title VII, and sections 721(c) and 761(b) of the Dodd-Frank Act provide the Commissions with authority to define the terms "swap" and "security-based swap," as well as the terms "swap dealer," "major swap participant," "security-based swap dealer," and "major security-based swap participant," to include transactions and entities that have been structured to evade the requirements of subtitles A and B, respectively, of Title VII.

Section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records requirements for SBSAs by persons registered as swap data repositories ("SDRs") under the CEA,[5] including uniform rules that specify the data elements that shall be collected and maintained by each SDR.[6] Similarly, section 712(d)(2)(C) of the Dodd-Frank Act

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contracts in effect prior to the effective date of such regulations are not considered swaps. See section 719(d) of the Dodd-Frank Act. The Commissions currently are conducting the required joint study and will consider whether to propose any implementing regulations (including, if appropriate, regulations determining that stable value contracts: i) are not encompassed within the swap definition; or ii) are encompassed within the definition but are exempt from the swap definition) at the conclusion of that study.

5 7 U.S.C. 1 et seq.

6 The CFTC has issued proposed rules regarding SDRs and, separately, swap data recordkeeping and reporting. See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, Nov. 23, 2010; Swap Data Recordkeeping and Reporting Requirements, 75 FR 76573, Dec. 8, 2010. The SEC has also issued proposed rules regarding security-based swap data repositories ("SBSDRs"), including rules specifying data collection and maintenance standards for SBSDRs, as well as rules regarding security-based swap data recordkeeping and reporting. See Security-Based Swap Data Repository Registration, Duties, and Core Principles, 75 FR 77306, Dec. 10, 2010; Regulation SBSR - Reporting and Dissemination of Security-Based Swap Information, 75 FR 75208, Dec. 2, 2010.

requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading records, for swap dealers, major swap participants, security-based swap dealers, and security-based swap participants.[7]

Under the comprehensive framework for regulating swaps and security-based swaps established in Title VII, the CFTC is given regulatory authority over swaps,[8] the SEC is given regulatory authority over security-based swaps,[9] and the Commissions shall jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.[10] In addition, the SEC is given antifraud authority over,

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7 The CFTC has issued proposed rules regarding recordkeeping requirements for swap dealers and major swap participants. See Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 FR 76666, Dec. 9, 2010.

8 Section 721(a) of the Dodd-Frank Act defines the term "swap" by adding section 1a(47) to the CEA, 7 U.S.C. 1a(47). This new swap definition also is cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69). Citations to provisions of the CEA and the Exchange Act, 15 U.S.C. 78a et seq., in this release refer to the numbering of those provisions after the effective date of Title VII, except as indicated.

9 Section 761(a) of the Dodd-Frank Act defines the term "security-based swap" by adding new section 3(a)(68) to the Exchange Act, 15 U.S.C. 78c(a)(68). This new security-based swap definition also is cross-referenced in new CEA section 1a(42), 7 U.S.C. 1a(42). The Dodd-Frank Act also explicitly includes security-based swaps in the definition of security under the Exchange Act and the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77a et seq.

10 Section 721(a) of the Dodd-Frank Act describes the category of "mixed swap" by adding new section 1a(47)(D) to the CEA, 7 U.S.C. 1a(47)(D). Section 761(a) of the Dodd-Frank Act also includes the category of "mixed swap" by adding new section 3(a)(68)(D) to the Exchange Act, 15 U.S.C. 78c(68)(D). A mixed swap is defined as a subset of security-based swaps that also are based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than the occurrence, non-occurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities

and access to information from, certain CFTC-regulated entities regarding SBSAs, which are a type of swap related to securities over which the CFTC is given regulatory authority.[11]

To assist the Commissions in further defining the Product Definitions (as well as certain other definitions) and in prescribing regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII, the Commissions published an advance notice of proposed rulemaking ("ANPR") in the Federal Register on August 20, 2010.[12]

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in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer).

11 Section 761(a) of the Dodd-Frank Act defines the term "security-based swap agreement" by adding new section 3(a)(78) to the Exchange Act, 15 U.S.C. 78c(a)(78). The CEA includes the definition of "security-based swap agreement" in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (see section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), whereas the definition of SBSA in the CEA does not contain a similar exclusion. Instead, under the CEA, the exclusion for security-based swaps is placed in the general exclusions from the swap definition (see CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)). Although the statutes are slightly different structurally, the Commissions interpret them to have consistent meaning that the category of security-based swap agreements excludes security-based swaps.

12 See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 FR 51429, Aug. 20, 2010. The ANPR also solicited comment regarding the definitions of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." These definitions are the subject of a separate joint proposed rulemaking by the Commissions. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 FR 80174, Dec. 21, 2010 ("Entity Definitions"). The Commissions also provided the public with the ability to present their views more generally on implementation of the Dodd-Frank Act through their websites, dedicated electronic mailboxes, and meetings with interested parties. See Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act/Meetings with SEC Officials located at http://www.sec.gov/spotlight/regreformcomments.shtml; Public Submissions, located at http://comments.cftc.gov/PublicComments/ReleasesWithComments.aspx; External Meetings, located at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm.

The comment period for the ANPR closed on September 20, 2010.[13] The Commissions received comments addressing the Product Definitions and/or mixed swaps in response to the ANPR, as well as comments in response to the Commissions' informal solicitations,[14] from a wide range of commenters.

The Commissions have reviewed the comments received, and the staffs of the Commissions have met with many market participants and other interested parties to discuss the definitions.[15] Moreover, the Commissions' staffs have consulted extensively with each other as required by sections 712(a)(1) and (2) of the Dodd-Frank Act and have consulted with staff of the Board as required by section 712(d) of the Dodd-Frank Act.

Based on this review and consultation, the Commissions are proposing interpretive guidance, and in some instances also proposing rules, regarding, among other things: i) the regulatory treatment of insurance products; ii) the exclusion of forward contracts from the swap and security-based swap definitions; iii) the regulatory treatment of certain consumer and commercial contracts; iv) the regulatory treatment of certain

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13 Copies of all comments received by the SEC on the ANPR are available on the SEC's Internet website, located at http://www.sec.gov/comments/s7-16-10/s71610.shtml. Comments are also available for website viewing and printing in the SEC's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of all comments received by the CFTC on the ANPR are available on the CFTC's Internet website, located at http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_2_Definitions.html.

14 <u>See</u> <u>supra</u> note 12.

15 Information about meetings that CFTC staff have had with outside organizations regarding the implementation of the Dodd-Frank Act is available at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm. Information about meetings that SEC staff have had with outside organizations regarding the product definitions is available at http://www.sec.gov/comments/s7-16-10/s71610.shtml#meetings. The views expressed in the comments in response to the ANPR, in response to the Commissions' informal solicitations, and at such meetings are collectively referred to as the views of "commenters."

foreign-exchange related and other instruments; v) swaps and security-based swaps involving interest rates (or other rates) and yields; vi) total return swaps ("TRS"); vii) the application of the definition of "narrow-based security index" in distinguishing between certain swaps and security-based swaps, including credit default swaps ("CDS") and index CDS; and viii) the specification of certain swaps and security-based swaps that are, and are not, mixed swaps. In addition, the Commissions are proposing rules: i) establishing books and records requirements applicable to SBSAs; ii) providing a mechanism for requesting the Commissions to interpret whether a particular type of agreement, contract, or transaction (or class of agreements, contracts, or transactions) is a swap, security-based swap, or both (i.e., a mixed swap); and iii) providing a mechanism for evaluating the applicability of certain regulatory requirements to particular mixed swaps. Finally, the CFTC is proposing rules to implement the anti-evasion authority provided in the Dodd-Frank Act.

The Commissions believe that the proposed rules and interpretive guidance will further the purposes of Title VII. While the Commissions believe that these proposals, if adopted, would appropriately effect the intent of the Dodd-Frank Act, the Commissions are very interested in commenters' views as to whether those purposes have been achieved, and, if not, how to improve these proposals.

II. Scope of Definitions of Swap and Security-Based Swap.

A. Introduction.

Title VII of the Dodd-Frank Act applies to a wide variety of agreements, contracts, and transactions classified as swaps or security-based swaps. The statute lists these agreements, contracts, and transactions in the definition of the term "swap."[16] The statutory definition of the term "swap" also has various exclusions,[17] rules of construction, and other provisions for the interpretation of the definition.[18] One of the exclusions to the definition of the term "swap" is for security-based swaps.[19] The term "security-based swap," in turn, is defined as an agreement, contract, or transaction that is a "swap" (without regard to the exclusion from that definition for security-based swaps) and that also has certain characteristics specified in the statute.[20] Thus, the statutory definition of the term "swap" also determines the scope of agreements, contracts, and transactions that could be security-based swaps.

The statutory definitions of "swap" and "security-based swap" are detailed and comprehensive, and the Commissions believe that extensive "further definition" of the terms by rule is not necessary. Nevertheless, several commenters have stated,[21] and the Commissions agree, that the definitions could be read to include certain types of agreements, contracts, and transactions that previously have not been considered swaps or security-based swaps and that nothing in the legislative history of the Dodd-Frank Act appears to suggest that Congress intended such agreements, contracts, and transactions to be regulated as swaps or security-based swaps under Title VII. The Commissions thus

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16 See CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A). This swap definition is also cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69).

17 See CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B), clauses (i)-(x).

18 See CEA sections 1a(47)(C)-(F), 7 U.S.C. 1a(47)(C)-(F).

19 See CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x).

20 See section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

21 See, e.g., Letter from Edward J. Rosen, Cleary Gottlieb Steen & Hamilton LLP, Sept. 21, 2010 ("Cleary Letter"); Letter from Robert Pickel, Executive Vice President, International Swaps and Derivatives Association, Inc., Sept. 20, 2010 ("ISDA Letter").

believe that it is important to clarify the treatment under the definitions of certain types of agreements, contracts, and transactions, such as insurance products and certain consumer and commercial contracts.

In addition, commenters also raised questions regarding, and the Commissions believe that it is important to clarify: i) the exclusion for forward contracts from the definitions of the terms "swap" and "security-based swap;" and ii) the status of certain commodity-related products (including various foreign exchange products and forward rate agreements ("FRAs")) under the definitions of the terms "swap" and "security-based swap." Finally, the Commissions are providing guidance regarding certain interpretive issues related to the definitions.[22]

B. Proposed Rules and Interpretive Guidance Regarding Certain Transactions Outside the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap."

1. Insurance Products.

A number of commenters expressed concern that the definitions of the terms "swap" and "security-based swap" potentially could include certain types of insurance products[23] because the statutory definition of the term "swap" includes, in part, any

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22 Some commenters raised concerns regarding the treatment of inter-affiliate swaps and security-based swaps. See, e.g., Cleary Letter; Letter from Coalition for Derivatives End Users, Sept. 20, 2010 ("CDEU Letter"); ISDA Letter; Letter from Richard A. Miller, Vice President and Corporate Counsel, Prudential Financial Inc., Sept. 17, 2010; Letter from Richard M. Whiting, The Financial Services Roundtable, Sept. 20, 2010. A few commenters suggested that the Commissions should further define the term "swap" or "security-based swap" to exclude inter-affiliate transactions. See Cleary Letter; CDEU Letter. The Commissions are considering whether inter-affiliate swaps or security-based swaps should be treated differently from other swaps or security-based swaps in the context of the Commissions' other Title VII rulemakings.

23 See, e.g., Letter from Ernest C. Goodrich, Jr., Managing Director – Legal Department, and Marcelo Riffaud, Managing Director – Legal Department, Deutsche Bank AG, Sept. 20, 2010 ("Deutsche Bank Letter"); Letter from Sean W. McCarthy, Chairman,

agreement, contract, or transaction "that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."[24] The Commissions do not interpret this clause to mean that products historically treated as insurance products should be included within the swap or security-based swap definition.[25]

The Commissions are aware of nothing in Title VII to suggest that Congress intended for insurance products to be regulated as swaps or security-based swaps. Moreover, that swaps and insurance products are subject to different regulatory regimes is reflected in section 722(b) of the Dodd-Frank Act which, in new section 12(h) of the CEA, provides that a swap "shall not be considered to be insurance" and "may not be

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Association of Financial Guaranty Insurers, Sept. 20, 2010 ("AFGI Letter"); Letter from Robert J. Duke, The Surety & Fidelity Association of America, Sept. 20, 2010 ("SFAA Letter"); Letter from J. Stephen Zielezienski, Senior Vice President & General Counsel, American Insurance Association, Sept. 20, 2010; Letter from Franklin W. Nutter, President, Reinsurance Association of America, Sept. 20, 2010 ("RAA Letter"); Letter from James M. Olsen, Senior Director Accounting and Investment Policy, Property Casualty Insurers Association of America, Sept. 17, 2010; Letter from Jane L. Cline, President, and Therese M. Vaughan, Chief Executive Officer, National Association of Insurance Commissioners, Sept. 20, 2010; Letter from Joseph W. Brown, Chief Executive Officer, MBIA Inc., Sept. 20, 2010 ("MBIA Letter"); Cleary Letter; Letter from White & Case LLP ("White & Case Letter"), Sept. 20, 2010; Letter from Carl B. Wilkerson, Vice President and Chief Counsel, Securities & Litigation, American Council of Life Insurers, Nov. 12, 2010 ("ACLI Letter"); Letter from Stephen E. Roth, James M. Cain, and W. Thomas Conner, Sutherland Asbill & Brennan LLP, for the Committee of Annuity Insurers, Dec. 3, 2010.

24 CEA section 1a(47)(A)(ii), 7 U.S.C. 1a(47)(A)(ii).

25 The Commissions also believe it was not the intent of Congress through the swap and security-based swap definitions to preclude the provision of insurance to individual homeowners and small businesses that purchase property and casualty insurance. See CEA section 2(e), 7 U.S.C. 2(e) and section 6(l) of the Exchange Act, 15 U.S.C. 78f(l) (prohibiting individuals and small businesses that do not meet specified financial thresholds or other conditions from entering into swaps or security-based swaps other than on or subject to the rules of regulated futures and securities exchanges).

regulated as an insurance contract under the law of any State."[26] Accordingly, the Commissions believe that state or federally regulated insurance products that are provided by state or federally regulated insurance companies[27] that otherwise could fall within the definitions should not be considered swaps or security-based swaps so long as they satisfy the proposed rules or comport with the related proposed interpretive guidance.[28] At the same time, however, the Commissions are concerned that agreements, contracts, or transactions that are swaps or security-based swaps might be characterized as insurance products to evade the regulatory regime under Title VII of the Dodd-Frank Act. Accordingly, the Commissions are proposing rules and interpretive guidance that would clarify that agreements, contracts, or transactions meeting certain requirements would be considered insurance and not swaps or security-based swaps.

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26 7 U.S.C. 16(h). Moreover, other provisions of the Dodd-Frank Act address the status of insurance more directly, and more extensively, than Title VII. For example, Title V of the Dodd-Frank Act requires the newly established Federal Insurance Office to conduct a study and submit a report to Congress, within 18 months of enactment of the Dodd-Frank Act, on the regulation of insurance, including the consideration of federal insurance regulation. Notably, the Federal Insurance Office's authority under Title V extends primarily to monitoring and information gathering; its ability to promulgate federal insurance regulation that preempts state insurance regulation is significantly restricted. See section 502 of the Dodd-Frank Act (codified in various sections of 31 U.S.C.). Title X of the Dodd-Frank Act also specifically excludes the business of insurance from regulation by the Bureau of Consumer Financial Protection. See section 1027(m) of the Dodd-Frank Act, 12 U.S.C. 5517(m) ("The [Bureau of Consumer Financial Protection] may not define as a financial product or service, by regulation or otherwise, engaging in the business of insurance."); section 1027(f) of the Dodd-Frank Act, 12 U.S.C. 5517(f) (excluding persons regulated by a state insurance regulator, except to the extent they are engaged in the offering or provision of consumer financial products or services or otherwise subject to certain consumer laws as set forth in Title X of the Dodd-Frank Act).

27 As discussed above, the establishment of the Federal Insurance Office under Title V of the Dodd-Frank Act suggests that federal insurance law could be established in the future. The Commissions believe that the proposed rules should, therefore, include a specific reference to federal insurance law.

28 To the extent an insurance product does not fall within the language of the swap definition by its terms, it would not need to satisfy the requirements under the proposed rules in order to avoid being considered a swap or security-based swap.

The proposed rules contain two subparts; the first subpart addresses the agreement, contract, or transaction and the second subpart addresses the entity providing that agreement, contract, or transaction. More specifically, with respect to the former, paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69-1 under the Exchange Act would clarify, as discussed in more detail below, that the terms "swap" and "security-based swap" would not include an agreement, contract, or transaction that, by its terms or by law, as a condition of performance:

- requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;
- requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;
- is not traded, separately from the insured interest, on an organized market or over-the-counter; and
- with respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.

In addition, the second subpart of the proposed rules, in paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69-1 under the Exchange Act, would require that, in order to be excluded from the swap and security-based swap definitions as an insurance product, the agreement, contract, or transaction must be provided:

- by a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any state[29] or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such state or the United States;

- by the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof; or

- in the case of reinsurance only, by a person located outside the United States to an insurance company that is eligible under the proposed rules, provided that: i) such person is not prohibited by any law of any state or of the United States from offering such agreement, contract, or transaction to such an insurance company; ii) the product to be reinsured meets the requirements under the proposed rules to be an insurance product; and iii) the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.[30]

In order for an agreement, contract, or transaction to qualify as an insurance product that would not be a swap or security-based swap: i) the agreement, contract, or transaction would have to meet the criteria in the first subpart of the proposed rules and ii) the person or entity providing the agreement, contract, or transaction would have to

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29 The term "State" is defined in section 3(a)(16) of the Exchange Act to mean "any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States." 15 U.S.C. 78c(a)(16). The CFTC is proposing to incorporate this definition into proposed rule 1.3(xxx)(4) for purposes of ensuring consistency between the CFTC and SEC rules further defining the term "swap."

30 The "cedant" is the insurer writing the risk being ceded or transferred to such person located outside the United States.

meet the criteria in the second subpart of the proposed rules.[31] The fact that an agreement, contract, or transaction qualifies as an insurance product does not exclude it from the swap or security-based swap definitions if it is not provided by a qualifying person or entity, nor does the fact that a product is regulated by an insurance regulator exclude it from the swap or security-based swap definitions if the agreement, contract, or transaction does not satisfy the criteria for insurance set forth in the proposed rules.[32]

In addition, the Commissions are proposing interpretive guidance to clarify that, independent of paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69-1 under the Exchange Act, certain insurance products do not fall within the swap or security-based swap definitions so long as they are provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69-1 under the Exchange Act.

a) Types of Insurance Products.[33]

Paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69-1 under the Exchange Act would set forth four criteria for an

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31 The Commissions note that certain variable life insurance and annuity products are securities and would not be swaps or security-based swaps regardless of whether they met the requirements under the proposed rules. See CEA section 1a(47)(B)(v), 7 U.S.C. 1a(47)(B)(v) (excluding from the definition of "swap" any "agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to — (I) the [Securities Act]; and (II) the [Exchange Act]"). See also SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (holding that a "flexible fund" annuity contract was not entitled to exemption under section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), for insurance and annuities); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (holding that a variable annuity was not entitled to exemption under section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), for insurance and annuities).

32 The Commissions note that Title VII provides flexibility to address the facts and circumstances of new products that may be marketed or sold as insurance, for the purpose of determining whether they satisfy the requirements of the proposed rules, through joint interpretations pursuant to section 712(d)(4) of the Dodd-Frank Act.

33 See supra note 23, regarding comments received addressing this criterion.

agreement, contract, or transaction to be considered insurance. First, the proposed rules would require that the beneficiary have an "insurable interest" underlying the agreement, contract, or transaction at every point in time during the term of the agreement, contract, or transaction for that agreement, contract, or transaction to qualify as insurance. The requirement that the beneficiary be at risk of loss (which could be an adverse financial, economic, or commercial consequence) with respect to the interest that is the subject of the agreement, contract, or transaction at all times throughout the term of the agreement, contract, or transaction would ensure that an insurance contract beneficiary has a stake in the interest on which the agreement, contract, or transaction is written.[34] Similarly, the provision of the proposed rules that would require the beneficiary to have the insurable interest continuously during the term of the agreement, contract, or transaction is designed to ensure that payment on the insurance product is inextricably connected to both the beneficiary and the interest on which the insurance product is written. In contrast to an insurance product, a CDS (which may be a swap or a security-based swap) does not require the purchaser of protection to hold any underlying obligation issued by the reference entity on which the CDS is written.[35]

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34 Requiring that a beneficiary of an insurance policy have a stake in the interest traditionally has been justified on public policy grounds. For example, a beneficiary that does not have a property right in a building might have an incentive to profit from arson.

35 Standard CDS documentation stipulates that the incurrence or demonstration of a loss may not be made a condition to the payment on the CDS or the performance of any obligation pursuant to the CDS. See, e.g., Int'l Swaps and Derivatives Ass'n, "2003 ISDA Credit Derivatives Definitions," art. 9.1(b)(i) (2003) ("2003 Definitions) ("[T]he parties will be obligated to perform . . . irrespective of the existence or amount of the parties' credit exposure to a Reference Entity, and Buyer need not suffer any loss nor provide evidence of any loss as a result of the occurrence of a Credit Event.").

Second, the requirement that an actual loss occur and be proved under the proposed rules similarly would ensure that the beneficiary has a stake in the insurable interest that is the subject of the agreement, contract, or transaction. If the beneficiary can demonstrate actual loss, that loss would "trigger" performance by the insurer on the agreement, contract, or transaction such that, by making payment, the insurer is indemnifying the beneficiary for such loss. In addition, limiting any payment or indemnification to the value of the insurable interest aids in distinguishing swaps and security-based swaps (where there is no such limit) from insurance.[36]

Third, the proposed rules would require that the insurance product not be traded, separately from the insured interest, on an organized market or over-the-counter. With limited exceptions,[37] insurance products traditionally have been neither entered into on or subject to the rules of an organized exchange nor traded in secondary market transactions (i.e., they are not traded on an organized market or over-the-counter). Whereas swaps and security-based swaps also generally have not been tradable at-will in secondary market transactions (i.e., on an organized market or over-the-counter) without counterparty consent, the Commissions understand that swaps and security-based swaps are routinely novated or assigned to third parties, usually pursuant to industry standard

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36 To the extent an insurance product provides for such items as, for example, a rental car for use while the car that is the subject of an automobile insurance policy is being repaired, the Commissions would consider such items as constituting part of the value of the insurable interest.

37 See, e.g., "Life Settlements Task Force, Staff Report to the United States Securities and Exchange Commission" ("In an effort to help make the bidding process more efficient and to facilitate trading of policies after the initial settlement occurs, some intermediaries have considered or instituted a trading platform for life settlements."), available at http://www.sec.gov/news/studies/2010/lifesettlements-report.pdf (July 22, 2010).

terms and documents.[38] For the foregoing reasons, the Commissions believe that lack of trading separately from the insured interest is a feature of insurance that is useful in distinguishing insurance from swaps and security-based swaps.

Fourth, the proposed rules would address financial guarantee policies, also known as bond insurance or bond wraps.[39] Although such products can be economically similar to products such as CDS, they have certain key characteristics that distinguish them from swaps and security-based swaps.[40] For example, under a financial guarantee policy, the insurer typically is required to make timely payment of any shortfalls in the payment of scheduled interest to the holders of the underlying guaranteed obligation. Also, for particular bonds that are covered by a financial guarantee policy, the indenture, related documentation, and/or the financial guarantee policy will provide that a default in

38 See, e.g., Int'l Swaps and Derivatives Ass'n, "2005 Novation Protocol," available at http://www.isda.org/2005novationprot/docs/NovationProtocol.pdf (2005); Int'l Swaps and Derivatives Ass'n, "ISDA Novation Protocol II," available at http://www.isda.org/isdanovationprotII/docs/NPII.pdf (2005); Int'l Swaps and Derivatives Ass'n, 2003 Definitions, supra note 35, Exhibits E (Novation Agreement) and F (Novation Confirmation).

39 Several commenters expressed concern that the swap and security-based swap definitions could encompass financial guarantee policies. See, e.g., AFGI Letter; Letter from James M. Michener, General Counsel, Assured Guaranty, Dec. 14, 2010 ("Assured Guaranty Letter"); MBIA Letter; Letter from the Committee on Futures and Derivatives Regulation of the New York City Bar Association, Sept. 20, 2010. Financial guarantee policies are used by entities such as municipalities to provide greater assurances to potential purchasers of their bonds and thus reduce their interest costs. See "Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities" (Aug. 28, 1987).

40 See, e.g., AFGI Letter (explaining the differences between financial guaranty policies and CDS); Letter from James M. Michener, General Counsel, Assured Guaranty, Sept. 13, 2010 (noting that the Financial Accounting Standards Board has issued separate guidance on accounting for financial guaranty insurance and CDS); Deutsche Bank Letter (noting that financial guaranty policies require the incurrence of loss for payment, whereas CDS do not).

payment of principal or interest on the underlying bond will not result in acceleration of the obligation of the insurer to make payment of the full amount of principal on the underlying guaranteed obligation unless the insurer, in its sole discretion, opts to make payment of principal prior to the final scheduled maturity date of the underlying guaranteed obligation. Conversely, under a CDS, a protection seller frequently is required to make payment of the relevant settlement amount to the protection buyer upon demand by the protection buyer after any credit event involving the issuer.[41]

The Commissions do not believe that financial guarantee policies, in general, should be regulated as swaps or security-based swaps. However, because of the close economic similarity of financial guarantee insurance policies guaranteeing payment on debt securities to CDS, the Commissions also are proposing that, in addition to the criteria noted above with respect to insurance generally, financial guarantee policies also would have to satisfy the requirement that they not permit the beneficiary of the policy to accelerate the payment of any principal due on the debt securities. This requirement would further distinguish financial guarantee policies from CDS because, as discussed above, the latter generally requires payment of the relevant settlement amount on the CDS after demand by the protection buyer.

The Commissions believe that requiring all of the criteria in paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69-1 under the Exchange Act would help limit the application of the proposed rules to

41 While a CDS requires payment in full on the occurrence of a credit event, the Commissions recognize that there are other financial instruments, such as corporate guarantees of commercial loans and letters of credit supporting payments on loans or debt securities, that allow for acceleration of payment obligations without such guarantees or letters of credit being swaps or security-based swaps.

products appropriately regulated as insurance and provide that products appropriately subject to the regulatory regime under Title VII of the Dodd-Frank Act are regulated as swaps or security-based swaps. As a result, the Commissions believe that these requirements would help prevent the proposed rules from being used to circumvent the applicability of the swap and security-based swap regulatory regimes under Title VII.

However, the Commissions are considering an additional criterion as well. One ANPR commenter suggested that the proposed rules require that, in order to qualify as insurance that is excluded from the swap definition, payment on an agreement, contract, or transaction not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity.[42] Such a requirement could help to prevent swaps from being executed in the guise of insurance in order to avoid the regulatory regime established by Title VII. It may ensure that an agreement, contract, or transaction is not treated as insurance if it is used for speculative purposes or to influence prices in derivatives markets. Yet, another ANPR commenter stated that such a requirement for an agreement, contract, or transaction to qualify as insurance rather than a swap "is not consistent with common variable life insurance and variable annuity products, which deliver insurance guarantees that do vary with the performance of specified assets."[43]

The Commissions request comment on whether, in order for an agreement, contract, or transaction to be considered insurance pursuant to paragraph (i) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (a) of proposed rule 3a69-1 under the Exchange Act, the Commissions should require that payment not be based on the price,

42 See Cleary Letter.

43 See ACLI Letter.

rate, or level of a financial instrument, asset, or interest or any commodity. If so, the Commissions also request comment on whether variable annuity contracts (where the income is subject to tax treatment under section 72 of the Internal Revenue Code) and variable universal life insurance should be excepted from such a requirement.[44]

Although the proposed criteria should appropriately identify agreements, contracts, and transactions that should be considered to be insurance, the Commissions also are proposing interpretive guidance that certain enumerated types of insurance products are outside the scope of the statutory definitions of swap and security-based swap under the Dodd-Frank Act. These products are surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and annuity products the income on which is subject to tax treatment under section 72 of the Internal Revenue Code.[45] The Commissions believe that these enumerated insurance products do not bear the characteristics of the transactions that Congress subjected to the regulatory regime for swaps and security-based swaps under the Dodd-Frank Act.[46] As a result, excluding these enumerated insurance products should appropriately place traditional insurance products outside the scope of the swap and security-based swap definitions. Such insurance products, however, would need to be provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69-1 under the Exchange Act, as discussed below, and such insurance products would need to be regulated as insurance.

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44 26 U.S.C. 72. See also supra note 31.

45 Id.

46 The list of enumerated insurance products is generally consistent with the provisions of section 302(c)(2) of the Gramm-Leach-Bliley Act ("GLBA"), 15 U.S.C. 6712(c)(2), which addresses insurance underwriting in national banks.

b) Providers of Insurance Products.

The second subpart of the proposed rules, in paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69-1 under the Exchange Act, would require that, in addition to meeting the product requirements discussed above (or being subject to the interpretive guidance regarding enumerated insurance products provided above) the agreement, contract, or transaction be provided by a person or entity that meets certain criteria. Generally, the product would have to be provided by a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by companies whose insurance business is subject to supervision by the insurance commissioner (or similar official or agency) of any state[47] or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such state or of the United States.[48]

The requirement that the agreement, contract, or transaction be provided by a state or federally regulated insurance company would help ensure that entities that are not regulated under insurance laws are not able to avoid regulation under Title VII of the Dodd-Frank Act as well. The Commissions believe that this requirement also should

47 See supra note 29, regarding the definition of "State" contained in the proposed rules.

48 This paragraph of the proposed rules is substantially similar to the definition of an insurance company under the federal securities laws. See section 2(a)(13) of the Securities Act, 15 U.S.C. 77b(a)(13); section 2(a)(17) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(17). These definitions also include reinsurance companies. In order to ensure regulatory consistency, the Commissions believe that it is appropriate to include substantially the same definition of an insurance company as currently exists elsewhere in the federal securities laws, but the Commissions are requesting comment regarding the role played by a receiver or similar official or any liquidating agent for such insurance company, in its capacity as such, rather than proposing this provision of the insurance company definition.

help prevent regulatory gaps that otherwise might exist between insurance regulation and the regulation of swaps and security-based swaps.

The proposed rules also would require that the agreement, contract, or transaction provided by the insurance company be regulated as insurance under the laws of the state in which it is regulated or the United States. The purpose of this proposed requirement is that an agreement, contract, or transaction that satisfies the other conditions of the proposed rules must be subject to regulatory oversight as an insurance product. As a result of the requirement that an insurance regulator must have determined that the agreement, contract, or transaction being sold is insurance (i.e., because state insurance regulators are banned from regulating swaps as insurance),[49] the Commissions believe that this condition would help prevent products that are swaps or security-based swaps from being characterized as insurance products in order to evade the regulatory regime under Title VII of the Dodd-Frank Act.

The Commissions also believe that it is appropriate to exclude insurance that is issued by the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof, from regulation as swaps or security-based swaps. Such insurance would include, for example, federal insurance of savings in banks, savings associations, and credit unions; catastrophic crop insurance; flood insurance; federal insurance of certain pension obligations; and terrorism risk insurance. Accordingly, the proposed rules would provide that products meeting the criteria discussed above that are required for an agreement, contract, or transaction to qualify as insurance are excluded from the swap and security-based swap definitions if they are

[49] See section 722(b) of the Dodd-Frank Act.

provided by the federal government or pursuant to a statutorily authorized program thereof.

Finally, the Commissions believe that where an agreement, contract, or transaction qualifies as insurance excluded from the swap and security-based swap definitions, the lawful reinsurance of that agreement, contract, or transaction similarly should be excluded. Such reinsurance would be excluded from the definitions even if the reinsurer is located abroad and is not state or federally regulated. Accordingly, the proposed rules would provide that an agreement, contract, or transaction of reinsurance would be excluded from the swap and security-based swap definitions if it is provided by a person located outside the United States, if such person is not prohibited by any law of any state or the United States from offering such reinsurance to a state or federally regulated insurance company, so long as the product to be reinsured meets the requirements under the proposed rules to be an insurance product, and the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

The proposed rules would cover only an agreement, contract, or transaction by an insurance company and would not affect the characterization of the asset that is being insured. For example, if an agreement, contract, or transaction insures or guarantees the payment on a security, the security would remain subject to all applicable securities laws. The guarantee agreement, contract, or transaction, however, would not be regulated as a swap or security-based swap if it meets all of the requirements of the proposed rules.[50]

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[50] The guarantee agreement, contract, or transaction, however, could itself be a security that is subject to the federal securities laws." See, e.g., section 2(a)(1) of the Securities Act,

One commenter has stated that monoline insurance companies (also called financial guarantors) continue to guarantee payments under interest rate swaps related to municipal debt.[51] The CFTC believes that an insurance "wrap" of a swap may not be sufficiently different from the underlying swap to suggest that Congress intended the former to fall outside the definition of the term "swap" in Title VII.

The SEC, however, believes that, where an agreement, contract, or transaction is a security-based swap, the insurance of that security-based swap should not be regulated pursuant to Title VII, provided that the insurance meets the proposed requirements discussed above.[52]

The Commissions request comment on this issue generally, and also on the particular questions set forth in the Request for Comment section below.

The Commissions also are considering whether the issuer of such insurance (or guarantee) in respect of swaps or security-based swaps entered into by an affiliate or third party could be considered to be a major swap participant or major security-based swap participant. The Commissions have requested comment in the proposing release for the

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15 U.S.C. 77b(a)(1) (including in the statutory definition of "security" a guarantee of a security).

51 See Letter from Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers Government Affairs Committee, Feb. 18, 2011, at 11-12 ("[F]inancial guarantors have often guaranteed, through the issuance of a financial guaranty insurance policy, the obligations of unaffiliated parties under swaps with other unaffiliated parties. These insurance policies typically cover obligations of municipalities under interest rate or basis swaps relating to bonds issued by municipalities or in connection with asset backed securities.").

52 See supra note 32.

definitions of the terms "major swap participant" and "major security-based swap participant."[53]

Request for Comment:

1. The Commissions request comment on all aspects of proposed rule 1.3(xxx)(4) under the CEA and proposed rule 3a69-1 under the Exchange Act and the interpretive guidance in this section.

2. Do the proposed criteria for identifying an agreement, contract, or transaction that would not fall within the swap or security-based swap definitions appropriately encompass insurance and reinsurance products? If not, what types of insurance or reinsurance products are not encompassed, and why?

3. Are there certain products that are commonly known as swaps or security-based swaps, or that more appropriately should be considered swaps or security-based swaps, that could satisfy the criteria in proposed rule 1.3(xxx)(4) under the CEA and proposed rule 3a69-1 under the Exchange Act?

4. Is the proposed requirement that the beneficiary of an agreement, contract, or transaction have an insurable interest that is the subject of the agreement, contract, or transaction, and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction in order for the agreement, contract, or transaction not to fall within the swap or security-based swap definition, an effective criterion in determining whether a product is insurance? Why or why not?

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53 See proposed Entity Definitions, supra note 12.

5. Is the proposed requirement that loss occur and be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest, in order for an agreement, contract, or transaction not to fall within the swap or security-based swap definition, an effective criterion in determining whether a product is insurance? Why or why not? Is the requirement that any payment or indemnification for proved loss be limited to the value of the insurable interest consistent with conventional insurance analysis across a broad range of products (including traditional property and casualty products)? Are there particular products where such a limitation would not be appropriate? If so, please provide a detailed description of such products and why such a limitation would not be appropriate.

6. Is the proposed requirement that the agreement, contract, or transaction is not traded, separately from the insured interest, on an organized market or over-the-counter, an effective criterion in determining whether a product is insurance? Why or why not?

7. Should the Commissions add, as a requirement for an insurance agreement, contract, or transaction to not be characterized as a swap, that the agreement, contract, or transaction not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity? Would such a requirement be an effective criterion in distinguishing insurance from swaps and security-based swaps? Why or why not? If so, should the Commissions add any carve outs from the requirement, such as, for example, variable universal life insurance, or annuity contracts where the income is subject to tax treatment under section 72 of the Internal Revenue Code? Why or why not? Would such a requirement help preclude the use of the proposed rules for products

that are swaps or security-based swaps? Why or why not? Would such a requirement preclude the use of the proposed rules for products that currently are insurance? If so, what insurance products would be precluded by such a requirement, and how? How are insurance payments determined today?

8. Is the proposed requirement that, with respect to financial guaranty insurance, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy be at the sole discretion of the insurer an effective criterion in determining whether a financial guaranty policy is insurance that does not fall within the swap or security-based swap definition? Why or why not?

9. Does the interpretive guidance proposed in this section appropriately identify certain enumerated insurance products as traditional insurance products that would not fall within the swap or security-based swap definition if the provider of the product satisfies the requirements of the proposed rules? Why or why not? Is the interpretive guidance proposed in this section sufficient? Why or why not? Are there additional types of traditional insurance that should be similarly enumerated? If so, which ones and why? Could the exclusion of any of the enumerated insurance products serve to exclude products that should be regulated as swaps or security-based swaps? If so, which ones and why? Should the enumerated insurance products be required to be provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69-1 under the Exchange Act? Why or why not? If not, please provide a detailed explanation of the insurance products that should not be subject to these requirements. Are there insurance products currently offered that do not

meet these criteria? If so, please provide details regarding such products and their providers.

10. The Commissions are proposing guidance that certain enumerated types of insurance products, including property and casualty insurance, are outside the scope of the statutory definitions of the terms "swap" and "security-based swap" under the Dodd-Frank Act. The Commissions request comment generally as to the proposed guidance regarding property and casualty insurance. The CFTC also requests comment on whether the products specified in section 302(c)(2) of the GLBA, which names certain insurance products, including private passenger or commercial automobile, homeowners, mortgage, commercial multiperil, general liability, professional liability, workers' compensation, fire and allied lines, farm owners multiperil, aircraft, fidelity, surety, medical malpractice, ocean marine, inland marine, and boiler and machinery insurance, should be considered traditional property and casualty insurance. Why or why not? If so, please provide an explanation of the product and how it differs from transactions that should be subject to the swap regulatory regime of the Dodd-Frank Act. The SEC also requests comment on whether the products specified in section 302(c)(2) of the GLBA should be enumerated in the Commissions' proposed guidance regarding property and casualty insurance as outside of the scope of the swap and security-based swap definitions? Are there other categories of traditional property and casualty insurance that should be specifically enumerated? If so, please provide a detailed description of such other categories of property and casualty insurance that should be specifically identified, and why. If there are certain types of property and casualty insurance that fall within the swap definition,

will that affect the ability of persons, including consumers and businesses, to protect their properties against losses? If so, please provide a detailed explanation.

11. Are there situations in which an insurance product may be assigned to another party that are not addressed by the criteria in proposed rule 1.3(xxx)(4) under the CEA and proposed rule 3a69-1 under the Exchange Act? Is additional clarification necessary to address such situations? If so, what clarification?

12. Is the proposed requirement that the agreement, contract, or transaction be provided by a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any state, as defined in section 3(a)(16) of the Exchange Act, or by the United States or an agency or instrumentality thereof, and that the agreement, contract, or transaction be regulated as insurance under the laws of such state or of the United States, an effective criterion in determining whether an agreement, contract, or transaction falls within the swap or security-based swap definition? Does it sufficiently preclude the use of the proposed rules by unregulated entities? Why or why not? Does it sufficiently prevent evasion of the requirements of Title VII with respect to agreements, contracts, or transactions that are swaps or security-based swaps? Why or why not?

13. Are there circumstances under which a receiver or similar official or any liquidating agency for a state or federally regulated insurance company, acting in its capacity as such, would be providing insurance rather than administering an insurance product that is provided by an insurance company? Please provide a detailed explanation

of any such circumstances. If there are such circumstances, should the proposed rules include a provision that an agreement, contract, or transaction that satisfies the criteria of insurance but that is provided by a receiver or similar official or any liquidating agency for a state or federally regulated insurance company, in its capacity as such, qualify as insurance that is excluded from the swap and security-based swap definition? Why or why not?

14. Do the proposed rules appropriately treat an agreement, contract, or transaction that satisfies the criteria of insurance but that is provided by the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof, as insurance that is excluded from the swap and security-based swap definition? Why or why not? Are there other types of government-issued insurance products that are not covered by paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69-1 under the Exchange Act? Do states or state agencies or instrumentalities provide insurance products? Should the proposed requirement also include a provision that the agreement, contract, or transaction can be provided by any state or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof? Why or why not?

15. Do the proposed rules appropriately treat reinsurance by a person located outside the United States of a product meeting the requirements for insurance under the proposed rules, so long as the total amount reimbursable by all of the reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant, as insurance excluded from the swap and security-based swap definitions if such person is not prohibited by any law of any state or of the United States from offering such reinsurance

to a state or federally regulated insurance company? Do these provisions of the proposed rules sufficiently prevent evasion of the requirements of Title VII with respect to agreements, contracts, or transactions that are swaps or security-based swaps? Why or why not?

16. Are there additional criteria for identifying contracts, agreements, or transactions that are insurance and not swaps or security-based swaps that the Commissions should consider? Please provide detailed information and empirical data, to the extent possible, supporting any suggested criteria.

17. Should the proposed rules relating to insurance include a provision related to whether a product is recognized at fair value on an ongoing basis with changes in fair value reflected in earnings under U.S. generally accepted accounting principles? If so, what specific challenges may be encountered in light of the proposed Accounting Standards Update "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities," issued by the Financial Accounting Standards Board ("FASB") on May 26, 2010? Is recognizing a product at fair value on an ongoing basis (with changes in fair value reflected in earnings) inconsistent with treating such a product as insurance rather than a swap or security-based swap? Why or why not? Please provide examples of specific products and their correct accounting treatment under U.S. generally accepted accounting principles.

18. Where an agreement, contract, or transaction falls within the swap definition, should insurance of that agreement, contract, or transaction also be included in the swap definition? Why or why not? Is the insurance wrap of a swap sufficiently different (economically or otherwise) from the swap that is insured? Why or why not?

Would the regulation of such swap "wraps" as swaps impose costs on or otherwise impact the underlying cash markets (e.g., the ability to issue, and cost of issuing, municipal debt)? Please quantify to the extent possible. Would treating such "wraps" as insurance falling outside the swap definition frustrate or undermine Title VII's objectives in regulating the swap markets in any way? Why or why not? Please provide empirical data and analysis to the extent possible.

19. Where an agreement, contract, or transaction falls within the security-based swap definition, should the insurance of that agreement, contract, or transaction also be included in the security-based swap definition? Why or why not? Would the regulation of insurance on a security-based swap as a security-based swap under Title VII impose costs or otherwise impact the underlying cash markets (e.g., the ability to issue, and cost of issuing, municipal debt)? Please quantify to the extent possible. Would regulating such products as insurance rather than as security-based swaps frustrate or undermine Title VII's objectives in regulating the security-based swap and swap markets? Why or why not? Please provide a detailed explanation and empirical data to the extent possible.

20. Should the proposed rules include a provision similar to section 302(c)(1) of the GLBA[54] that would provide that any product regulated as insurance before July 21, 2010 (the date the Dodd-Frank Act was signed into law) and provided in accordance with paragraph (ii) of proposed rule 1.3(xxx)(4) under the CEA and paragraph (b) of proposed rule 3a69-1 would be considered insurance and not fall within the swap definition? Why or why not? Should different criteria apply to products regulated as insurance before July

[54] 15 U.S.C. 6712(c)(1).

21, 2010? Why or why not? If so, please provide a detailed description of what different criteria should apply.

21. The Commissions understand that swap guarantees may be offered by non-insurance companies. Should the Commissions provide guidance as to whether swap or security-based swap guarantees (that are not guarantees or insurance policies offered by insurance companies discussed above) should be considered swaps or security-based swaps? Why or why not?

2. The Forward Contract Exclusion.

The definitions of the terms "swap" and "security-based swap" do not include forward contracts. They exclude "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[55] Commenters have requested guidance from the Commissions regarding the scope of this exclusion. The Commissions believe it is appropriate to provide guidance to market participants regarding the applicability of the exclusion from the definitions of swap and security-based swap for forward contracts with respect to nonfinancial commodities[56] and securities.

a) Forward Contracts in Nonfinancial Commodities.

The wording of the forward contract exclusion from the swap definition with respect to nonfinancial commodities is similar, but not identical, to the forward contract exclusion from the definition of "future delivery" in the CEA, which excludes "any sale

[55] CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

[56] The discussion in subsections a) and b) of this section applies solely to the exclusion of nonfinancial commodity forwards from the swap definition in the Dodd-Frank Act.

of any cash commodity for deferred shipment or delivery."[57] Several ANPR commenters expressed the view that, with respect to nonfinancial commodities, the forward contract exclusion from the swap definition should be interpreted in the same manner as the CFTC has interpreted the forward contract exclusion from the term "future delivery" and, in particular, that the CFTC's "Brent Interpretation"[58] should apply to "book out" transactions for purposes of the forward exclusion from the swap definition.[59] The CFTC believes that clarification of the scope of the forward contract exclusion from the swap

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57 CEA section 1a(27), 7 U.S.C. 1a(27). The CEA does not define the term "futures contract." Rather, the CEA refers to a futures contract as a "contract of sale of a commodity for future delivery." See, e.g., CEA section 2(a)(1)(A), 7 U.S.C. 2(a)(1)(A) (providing the CFTC with exclusive jurisdiction over "contracts of sale of a commodity for future delivery" (other than security futures) traded or executed on, among other things, a designated contract market ("DCM")); CEA section 4(a), 7 U.S.C. 6(a) (a "contract for the purchase or sale of a commodity for future delivery" other than a contract made on an exchange located outside the United States must be conducted on or subject to the rules of, among other things, a DCM). Accordingly, by excluding forward contracts from the CEA's definition of the term "future delivery," the CEA provides that a forward contract is not a contract of sale of a commodity for future delivery and, hence, not a futures contract.

58 Statutory Interpretation Concerning Forward Transactions, 55 FR 39188, Sept. 25, 1990 ("Brent Interpretation").

59 See Letter from Joanne T. Medero, Managing Director, BlackRock, Sept. 20, 2010 ("BlackRock Letter"), Letter from Matt Schatzman, Senior Vice President, Energy Marketing, BG Americas and Global LNC, Sept. 20, 2010 ("BG Letter"); Cleary Letter; Letter from Edward W. Gallagher, President, Dairy Risk Management Services, a division of Dairy Farmers of America, Inc., Sept. 20, 2010 ("DFA Letter"); Letter from Eric Dennison, Sr. Vice President and General Counsel, Stephanie Miller, Assistant General Counsel – Commodities, and Bill Hellinghausen, Director of Regulatory Affairs, EDF Trading North America, LLC, Sept. 20, 2010 ("EDF Letter"); Richard F. McMahon, Jr., Executive Director, Edison Electric Institute, Sept. 20, 2010 ("EEI Letter"); Letter from John M. Damgard, President, Futures Industry Association, Sept. 20, 2010 ("FIA Letter"); Letter from Richard Ostrander, Managing Director and Counsel, Morgan Stanley, Sept. 20, 2010 ("Morgan Stanley Letter"); Letter of Michael Greenberger, JD, Law School Professor, University of Maryland School of Law, Sept. 20, 2010 ("University of Maryland Letter"); R. Michael Sweeney, Jr., Mark W. Menezes, and David T. McIndoe, Hunton & Williams, LLP, on behalf of the Working Group of Commercial Energy Firms, Sept, 20, 2010 ("WGCEF Letter"); Letter from Paul H. Stebbins, Chairman and Chief Executive Officer, World Fuel Services Corporation, Sept. 17, 2010 ("World Fuel Letter").

definition with respect to nonfinancial commodities is appropriate.[60]

Forward contracts with respect to nonfinancial commodities are commercial merchandising transactions. The primary purpose of the contract is to transfer ownership of the commodity and not to transfer solely its price risk. The CFTC has noted:

> The underlying postulate of the [forward] exclusion is that the [CEA's] regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.[61]

The CFTC believes that the forward contract exclusion in the Dodd-Frank Act with respect to nonfinancial commodities should be read consistently with this established, historical understanding that a forward contract is a commercial merchandising transaction.

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60 As discussed in part II.D.1 below, the terminology and documentation used by the parties are not dispositive of whether a particular agreement, contract, or transaction is a swap or security-based swap under the CEA or Exchange Act. Thus, if an agreement, contract, or transaction with respect to a nonfinancial commodity qualifies for the forward exclusion from the swap definition, it would not be a swap even if the parties refer to it as a swap or document it using an industry standard form agreement that is typically used for swaps. Conversely, such an agreement, contract, or transaction that does not qualify for the forward exclusion from the swap definition would not be excluded even if the parties refer to it as a forward contract.

61 Brent Interpretation, supra note 58, at 39190. The CFTC has reiterated this view in more recent adjudicative orders. See, e.g., In re Grain Land Coop., [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636 (CFTC Nov. 25, 2003); In re Competitive Strategies for Agric., Ltd., [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,635 (CFTC Nov. 25, 2003). Courts have expressed this view as well. See, e.g., Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 971 (4th Cir. 1993) ("[C]ash forwards are generally individually negotiated sales . . . in which actual delivery of the commodity is anticipated, but is deferred for reasons of commercial convenience or necessity."); CFTC v. Int'l Fin. Serv. (N.Y.), 323 F. Supp. 2d 482, 495 (S.D.N.Y. 2004). See also CFTC v. Co Petro Mktg. Grp., Inc., 680 F.2d 573, 579-580 (9th Cir. 1982); CFTC v. Noble Metals Int'l, Inc., 67 F.3d 766, 772-773 (9th Cir. 1995; CFTC v. Am. Metal Exch. Corp., 693 F. Supp. 168, 192 (D.N.J. 1988); CFTC v. Morgan, Harris & Scott, Ltd., 484 F. Supp. 669, 675 (S.D.N.Y. 1979) (forward contract exclusion does not apply to speculative transactions in which delivery obligations can be extinguished under the terms of the contract or avoided for reasons other than commercial convenience or necessity).

Many commenters discussed the issue of whether the requirement in the Dodd-Frank Act that a transaction be "intended to be physically settled" in order to qualify for the forward exclusion from the swap definition with respect to nonfinancial commodities reflects a change in the standard for determining whether a transaction is a forward contract.[62] Because a forward contract is a commercial merchandising transaction, intent to deliver historically has been an element of the CFTC's analysis of whether a particular contract is a forward contract.[63] In assessing the parties' expectations or intent regarding

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62 See, e.g., BG Letter (forward exclusion for swaps should be consistent with the forward exclusion from futures); BlackRock Letter (the CFTC should interpret "intended to be physically settled" consistently with existing CFTC principles, including book outs); DFA Letter (forward exclusion for swaps should be interpreted consistently with the CFTC's prior forward contract interpretations and precedent, including forwards requiring delivery but including embedded options); EDF Letter (forward exclusion from the definition of swap should be construed in a consistent manner with the forward exclusion under the CEA); EEI Letter (forward exclusion from swap definition should be interpreted consistently with the forward exclusion from futures); FIA Letter (the Commissions should, through rulemaking or interpretation, provide that the "intent" standard in the forward exclusion with respect to swaps will be interpreted the same as the existing forward exclusion with respect to futures); Morgan Stanley Letter (the forward exclusion from the swap definition should be interpreted consistently with the forward exclusion from futures); University of Maryland Letter (forward exclusion from swap definition intended to be consistent with the forward exclusion from futures); WGCEF Letter (physical delivery forwards should be distinguished from swaps under standards identical to those used in forwards vs. futures); World Fuel Letter (forward exclusion for swaps should be interpreted in a manner consistent with the forward exclusion from futures).

63 As recently as October 25, 2010, the CFTC observed in In re Wright that "it is well-established that the intent to make or take delivery is the critical factor in determining whether a contract qualifies as a forward." In re Wright, CFTC Docket No. 97-02, 2010 WL 4388247 at *3 (CFTC Oct. 25, 2010) (citing In re Stovall, et al., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) 20,941 (CFTC Dec. 6, 1979); Brent Interpretation, supra note 58). In Wright, the CFTC noted that "[i]n distinguishing futures from forwards, the [CFTC] and the courts have assessed the transaction as a whole with a critical eye toward its underlying purpose. Such an assessment entails a review of the overall effect of the transaction as well as a determination as to what the parties intended." Id. at *3 (quoting Policy Statement Concerning Swap Transactions, 54 FR 30694, July 21, 1989 ("Swap Policy Statement") (citations and internal quotations omitted).

delivery, the CFTC consistently has applied a "facts and circumstances" test.[64] Therefore, the CFTC reads the "intended to be physically settled" language in the swap definition with respect to nonfinancial commodities to reflect a directive that intent to deliver a physical commodity be a part of the analysis of whether a given contract is a forward contract or a swap, just as it is a part of the CFTC's analysis of whether a given contract is a forward contract or a futures contract.

Commenters also requested clarification of the treatment of one type of forward contract – "book-out" transactions – in the context of the forward exclusion from the swap definition with respect to nonfinancial commodities. The issue of book-outs first arose in 1990 in the Brent Interpretation[65] because the parties to the crude oil contracts in that case could individually negotiate cancellation agreements, or "book-outs," with other parties.[66] In describing these transactions, the CFTC stated:

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64 In its recent decision in In re Wright, the CFTC applied its facts and circumstances test in an administrative enforcement action involving hedge-to-arrive contracts for corn, and observed that "[o]ur views of the appropriateness of a multi-factor analysis remain unchanged." Wright, supra note 63, n.13. The CFTC let stand the administrative law judge's conclusion that the hedge-to-arrive contracts at issue in the case were forward contracts. Id. at **5-6. See also Grain Land, supra note 61; Competitive Strategies for Agric., supra note 61.

65 See Brent Interpretation, supra note 58. The CFTC issued the Brent Interpretation in response to a federal court decision that held that certain 15-day Brent system crude oil contracts were illegal off-exchange futures contracts. See Transnor (Bermuda) Ltd. v. BP N. Am. Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1990). The Brent Interpretation provided clarification that the 15-day Brent system crude oil contracts were forward contracts that were excluded from the CEA definition of "future delivery," and thus were not futures contracts. See Brent Interpretation, supra note 58.

66 The Brent Interpretation described these "book-outs" as follows: "In the course of entering into 15-day contracts for delivery of a cargo during a particular month, situations often arise in which two counterparties have multiple, offsetting positions with each other. These situations arise as a result of the effectuation of multiple, independent commercial transactions. In such circumstances, rather than requiring the effectuation of redundant deliveries and the assumption of the credit, delivery and related risks attendant thereto, the parties may, but are not obligated to and may elect not to, terminate their

> It is noteworthy that while such [book-out] agreements may extinguish a party's delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.[67]

Thus, in the scenario at issue in the Brent Interpretation, the contracts created a binding obligation to make or take delivery without providing any right to offset, cancel, or settle on a payment-of-differences basis. The "parties enter[ed] into such contracts with the recognition that they may be required to make or take delivery."[68]

On these facts, the Brent Interpretation concluded that the contracts were forward contracts, not futures contracts:

> Under these circumstances, the [CFTC] is of the view that transactions of this type which are entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve, in certain circumstances, string or chain deliveries of the type described . . . are within the scope of the [forward contract] exclusion from the [CFTC's] regulatory jurisdiction.[69]

Although the CFTC did not expressly discuss intent to deliver, the Brent Interpretation concluded that transactions retained their character as commercial

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contracts and forego such deliveries and instead negotiate payment-of-differences pursuant to a separate, individually-negotiated cancellation agreement referred to as a 'book-out.' Similarly, situations regularly arise when participants find themselves selling and purchasing oil more than once in the delivery chain for a particular cargo. The participants comprising these 'circles' or 'loops' will frequently attempt to negotiate separate cancellation agreements among themselves for the same reasons and with the same effect described above." Brent Interpretation, supra note 58, at 39190.

67 Id. at 39192.

68 Id. at 39189.

69 Id. at 39192.

merchandising transactions, notwithstanding the practice of terminating commercial parties' delivery obligations through "book-outs" as described. At any point in the chain, one of the parties could refuse to enter into a new contract to book-out the transaction and, instead, insist upon delivery pursuant to the parties' obligations under their contract.

The CFTC believes that the principles underlying the Brent Interpretation similarly should apply to the forward exclusion from the swap definition with respect to nonfinancial commodities. To summarize, then, the CFTC believes that: i) the forward contract exclusion from the swap definition with respect to nonfinancial commodities should be interpreted in a manner that is consistent with the CFTC's historical interpretation of the forward contract exclusion from the definition of the term "future delivery;" ii) intent to deliver is an essential element of a forward contract excluded from both the swap and future delivery definitions, and such intent in both instances should be evaluated based on the CFTC's established multi-factor approach; and iii) book-out transactions in nonfinancial commodities that meet the requirements specified in the Brent Interpretation, and that are effectuated through a subsequent, separately-negotiated agreement, should qualify for the forward exclusion from the swap definition.[70]

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[70] This interpretive guidance is consistent with legislative history. See 156 Cong. Rec. H5247 (June 30, 2010) (colloquy between U. S. House Committee on Agriculture Chairman Collin Peterson and Representative Leonard Boswell during the debate on the Conference Report for the Dodd-Frank Act, in which Chairman Peterson stated: "Excluding physical forward contracts, including book-outs, is consistent with the CFTC's longstanding view that physical forward contracts in which the parties later agree to book-out their delivery obligations for commercial convenience are excluded from its jurisdiction. Nothing in this legislation changes that result with respect to commercial forward contracts."). See also 156 Cong. Rec. H5248-49 (June 30, 2010) (introducing into the record a letter authored by Senator Blanche Lincoln, Chairman of the U. S. Senate Committee on Agriculture, Nutrition and Forestry, and Christopher Dodd, Chairman U. S. Senate Committee on Banking, Housing, and Urban Affairs, stating that the CFTC is encouraged "to clarify through rulemaking that the exclusion from the definition of swap for 'any sale of a nonfinancial commodity or security for deferred

As noted above, the Brent Interpretation applies to "commercial participants in connection with their business."[71] Market participants that regularly make or take delivery of the referenced commodity (in the case of the Brent Interpretation, a tanker full of Brent oil) in the ordinary course of their business meet that standard. Such entities qualify for the forward exclusion from both the future delivery and swap definitions for their forward transactions under the Brent Interpretation even if they enter a subsequent transaction to "book out" the forward contract rather than make or take delivery. Intent to make or take delivery can be inferred from the binding delivery obligation for the referenced commodity in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the contract in the ordinary course of their business.

Some commenters to the ANPR requested clarification with regard to the application of the CFTC's 1993 order exempting certain energy contracts from regulation under the CEA (the "Energy Exemption")[72] after enactment of the Dodd-Frank Act.[73]

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shipment or delivery, so long as the transaction is intended to be physically settled' is intended to be consistent with the forward contract exclusion that is currently in the [CEA] and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to 'book-out' their physical delivery obligations under a forward contract.").

71 See Brent Interpretation, supra note 58, at 39192.

72 Exemption for Certain Contracts Involving Energy Products, 58 FR 21286, Apr. 20, 1993. The Energy Exemption generally applies to certain energy contracts: i) entered into by persons reasonably believed to be within a specified class of commercial and governmental entities; ii) that are bilateral contracts between two parties acting as principals; iii) the material economic terms of which are subject to individual negotiation by the parties; and iv) that impose binding obligations on the parties to make and receive delivery of the underlying commodity, with no right of either party to effect a cash settlement of their obligations without the consent of the other party (except pursuant to a bona fide termination right such as default). Like the Brent Interpretation, the Energy Exemption provides that the parties can enter into a subsequent book-out settlement of

The Energy Exemption extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil. The CFTC believes that the book-out provisions of the Brent Interpretation similarly should apply to the forward contract exclusion from the swap definition for nonfinancial commodities besides oil. Further, the CFTC also is proposing interpretive guidance herein that the Brent Interpretation with respect to the application of the forward contract exclusion from the term "future delivery" in the context of book-out transactions applies not just to oil, but to all nonfinancial commodities. The CFTC, therefore, is proposing to withdraw the Energy Exemption, while retaining and extending through this interpretive guidance the Brent Interpretation regarding book-outs under the forward contract exclusion with respect to nonfinancial commodities.[74]

b) Commodity Options and Commodity Options Embedded in Forward Contracts.

Some commenters responding to the ANPR requested clarification regarding the status of commodity options under the swap definition.[75] Questions also were raised

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the obligation in a manner other than by physical delivery of the commodity specified in the contract. Id. at 21294.

73 See, e.g., WGCEF letter. The CFTC issued the Energy Exemption shortly after Congress had provided the CFTC with exemptive authority pursuant to CEA section 4(c), 7 U.S.C. 6(c), in section 502 of the Futures Trading Practices Act of 1992, Pub. L. 102-546, 106 Stat. 3590 (1993).

74 To avoid any uncertainty, the CFTC also notes that the Dodd-Frank Act supersedes the Swap Policy Statement. The CFTC is aware that some commenters have suggested that the Commissions should exercise their authority to further define the term "eligible contract participant" to encompass the "line of business" provision of the Swap Policy Statement. See Swap Policy Statement, supra note 63, at 30696-30697. The Commissions will address these comments in their joint final rulemaking with respect to the Entity Definitions. See supra note 12.

75 See, e.g., World Fuel Letter (exclusion for commercial options set forth in CFTC Regulation 32.4 should also be an exclusion from the swap definition).

regarding options embedded in forward contracts, i.e., whether a forward contract with respect to a nonfinancial commodity that contains an embedded option can still qualify for the forward contract exclusion from the swap definition.[76]

The statutory swap definition explicitly provides that commodity options are swaps.[77] Accordingly, the CFTC recently proposed revisions to its existing options rules in parts 32 and 33 of its regulations with respect to the treatment of commodity options under the Dodd-Frank Act, and requested public comment on those proposed revisions.[78] The question of the application of the forward exclusion from the swap definition with respect to nonfinancial commodities, where commodity options are embedded in forward contracts (including embedded options to cash settle such contracts), is similar to that arising under the CEA's existing forward contract exclusion from the definition of the term "future delivery." The CFTC's Office of General Counsel addressed forward contracts that contained embedded options in a 1985 interpretive statement ("1985 Interpretation"),[79] which the CFTC recently adhered to in its adjudicatory Order in the

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76 See, e.g., Letter from Patrick Kelly, Policy Advisor, API, Sept. 20, 2010 ("API Letter"), EEI Letter; Letter from Daniel S.M. Dolan, VP, Policy Research & Communications, Electric Power Supply Association, Sept. 20, 2010 ("EPSA Letter") (physically settled options should be included in the forward exclusion from the swap definition); DFA Letter; ISDA Letter. One commenter suggested that the CFTC should apply to each contract with an enforceable delivery obligation a rebuttable presumption of intent to deliver, even if an option to cash settle is included in that contract. See WGCEF Letter.

77 7 U.S.C. 1a(47)(A)(i). Options on securities and certain options on foreign currency are excluded from the swap definition by CEA sections 1a(47)(B)(iii) and (iv), respectively. 7 U.S.C. 1a(47)(B)(iii) and (iv). These options are not subject to the Commissions' proposed guidance in this section.

78 See Commodity Options and Agricultural Swaps, 76 FR 6095, Feb. 3, 2011.

79 See Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 FR 39656, Sept. 30, 1985.

Wright case.[80] While both were issued prior to the effective date of the Dodd-Frank Act, the CFTC believes that it would be appropriate to apply this guidance to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act.

In Wright, the CFTC described the 1985 Interpretation and stated that the CFTC traditionally has engaged in a two-step analysis of "embedded options" in which the first step focuses on whether the option operates on the price or the delivery term of the forward contract and the second step focuses on secondary trading.[81] The CFTC believes that these same principles can be applied with respect to the forward contract exclusion from the swap definition for nonfinancial commodities in the Dodd-Frank Act, too. That is, a forward contract that contains an embedded commodity option or options[82] would be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s): i) may be used to adjust the forward contract price, but do not undermine the overall nature of the contract as a forward contract; ii) do not target the delivery term, so that the predominant feature of the contract is actual delivery; and iii)

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80 Wright, supra note 63.

81 Id. at n.5. In Wright, the CFTC affirmed the Administrative Law Judge's holding that an option embedded in a hedge-to-arrive contract did not violate CFTC rules regarding the sale of agricultural trade options. The CFTC first concluded that the puts at issue operated to adjust the forward price and did not render the farmer's overall obligation to make delivery optional. Then, turning to the next step of the analysis, the CFTC explained that "the put and [hedge-to-arrive contract] operated as a single contract, and in most cases were issued simultaneously . . . .We do not find that any put was severed from its forward or that either of [the put or the hedge-to-arrive contract] was traded separately from the other. We hold that in these circumstances, no freestanding option came into being . . . ." Id. at *7.

82 The CFTC believes that "options" in the plural would include, for example, a situation in which the embedded optionality involves option combinations, such as costless collars, that operate on the price term of the agreement, contract, or transaction.

cannot be severed and marketed separately from the overall forward contract in which they are embedded.[83] Conversely, where the embedded commodity option(s) render delivery optional, the predominant feature of the contract cannot be actual delivery and, therefore, the embedded option(s) to not deliver preclude treatment of the contract as a forward contract for a nonfinancial commodity. The CFTC would look to the specific facts and circumstances of the transaction as a whole to evaluate whether any embedded optionality operates on the price or delivery term of the contract, and whether an embedded commodity option is marketed or traded separately from the underlying contract, to determine whether that transaction qualifies for the forward contract exclusion from the swap definition for nonfinancial commodities.[84] The CFTC believes that such an approach would help prevent commodity options that should fall within the swap definition from qualifying for the forward contract exclusion for nonfinancial commodities instead.

c) Security Forwards.[85]

No commenters sought clarification of the exclusion from the swap and security-based swap definitions for the "sale of a nonfinancial commodity or security for deferred

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83 See Wright, supra note 63, at **6-7.

84 This facts and circumstances approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion for nonfinancial commodities is consistent with the CFTC's historical approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion from the CEA definition of the term "future delivery." See Wright, supra note 63, at *5 ("As we have held since Stovall, the nature of a contract involves a multi-factor analysis . . . .").

85 The discussion above regarding the exclusion from the swap definition for forward contracts on nonfinancial commodities does not apply to the exclusion from the swap and security-based swap definitions for security forwards or to the distinction between security forwards and security futures products.

shipment or delivery, so long as the transaction is intended to be physically settled," in the context of most sales of securities for deferred shipment or delivery; however, some commenters sought clarification of this exclusion in the context of mortgage securitizations.[86] The Commissions believe it is appropriate to address how the exclusions from the definitions of swap and security-based swap apply to security forwards and other purchases and sales of securities.

The Dodd-Frank Act excludes purchases and sales of securities from the definitions of swap and security-based swap in a number of different clauses.[87] Under these exclusions, purchases and sales of securities on a fixed or contingent basis[88] and sales of securities for deferred shipment or delivery that are intended to be physically delivered[89] are explicitly excluded from the definitions of swap and security-based

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86 Specifically, commenters requested clarification that the swap and security-based swap definitions do not include buying and selling mortgages and forward trading of agency (i.e., Federal Home Loan Mortgage Corporation ("Freddie Mac"), Federal National Mortgage Association ("Fannie Mae"), and Government National Mortgage Association ("Ginnie Mae") mortgage-backed securities ("MBS") in the "To-Be-Announced" ("TBA") market in order to provide the certainty needed to avoid unnecessary disruption of the securitization market. See Letter from Stephen H. McElhennon, Vice President & Deputy General Counsel, Fannie Mae, Sept. 20, 2010 ("Fannie Mae Letter"); Letter from Lisa M. Ledbetter, Freddie Mac, Sept. 20, 2010.

87 See CEA sections 1a(47)(B)(ii), (v), and (vi), 7 U.S.C. 1a(47)(B)(ii), (v), and (vi).

88 See CEA section 1a(47)(B)(v), 7 U.S.C. 1a(47)(B)(v) (excluding from the swap and security-based swap definitions "any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to [the Securities Act and Exchange Act]"); CEA section 1a(47)(B)(vi), 7 U.S.C. 1a(47)(B)(vi) (excluding from the swap and security-based swap definitions "any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a contingent basis that is subject to [the Securities Act and Exchange Act], unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction").

89 See CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

swap.[90] The exclusion from the definitions of swap and security-based swap of a sale of a security for deferred shipment or delivery involves an agreement to purchase securities, or groups or indexes of securities, at a future date at a certain price.

As with other purchases and sales of securities, security forwards are excluded from the definitions of swap and security-based swap. The sale of the security in this case occurs at the time the forward contract is entered into with the performance of the contract deferred or delayed. If such agreement, contract, or transaction is intended to be physically settled, the Commissions believe it would be within the security forward exclusion and therefore outside the swap and security-based swap definitions.[91] Moreover, as a purchase or sale of a security, the Commissions believe it also would be within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and, therefore, outside the swap and security-based swap definitions.[92]

As noted above, commenters requested specific guidance in the context of forward sales of MBS that are guaranteed or sold by Fannie Mae, Freddie Mac, and Ginnie Mae and the mortgages underlying such MBS.

MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae are eligible to be sold in the TBA market, which is essentially a forward or delayed delivery market.[93] The TBA market has been described as one that "allows mortgage lenders

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90 The Commissions note that calling an agreement, contract, or transaction a swap or security-based swap does not determine its status. See discussion supra part II.D.1.

91 See CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

92 See CEA sections 1a(47)(B)(v) and (vi), 7 U.S.C. 1a(47)(B)(v) and (vi).

93 Task Force on Mortgage-Backed Securities Disclosure, "Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets," part II.E.2 (Jan. 2003).

essentially to sell the loans they intend to fund even before the loans are closed."[94] In the TBA market, the lender enters into a forward contract to sell MBS and agrees to deliver MBS on the settlement date in the future. The specific MBS that will be delivered in the future may not yet be created at the time the forward contract is entered into.[95] The Commissions believe that such forward sales of MBS in the TBA market would fall within the exclusion for sales of securities on a deferred settlement or delivery basis even though the precise MBS are not in existence at the time the forward MBS sale is entered into.[96] Moreover, as the purchase or sale of a security, the Commissions believe such forward sales of MBS in the TBA market would fall within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and therefore outside the swap and security-based swap definitions.[97]

Request for Comment:

22. The Commissions request comment on all aspects of the proposed interpretive guidance set forth in this section regarding the forward contract exclusion from the swap and security-based swap definitions with respect to nonfinancial commodities and securities.

23. Is the proposed interpretive guidance set forth in this section sufficient with respect to the application of the forward contract exclusion from the swap definition with respect to nonfinancial commodities? If not, what changes should be made? Commenters also are invited to comment on whether the application of the Brent

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94 Id.

95 Id.

96 See CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

97 See CEA sections 1a(47)(B)(v) and (vi), 7 U.S.C. 1a(47)(B)(v) and (vi).

Interpretation generally, and its conclusions regarding book-outs in particular, is appropriate to the forward exclusion from the swap definition with respect to nonfinancial commodities. Would it permit transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act?

24. Is it appropriate, in light of the Dodd-Frank Act, for the CFTC to withdraw the Energy Exemption while concurrently retaining the Brent Interpretation, and extending it to the forward contract exclusion from the definition of "future delivery" and the swap definition, for book-out transactions in all nonfinancial commodities? Why or why not? Is the conclusion that the Dodd-Frank Act supersedes the Swap Policy Statement appropriate? Why or why not?

25. Are there any provisions of the Energy Exemption or Swap Policy Statement that the Commissions should consider incorporating into the definitions rulemakings (other than the request already submitted by some commenters in response to the proposed Entity Definitions that the "line of business" provision of the Swap Policy Statement be incorporated into the definition of the term "eligible contract participant" ("ECP"))? If so, please explain in detail how such provisions are consistent with the requirements of the Dodd-Frank Act and would not permit transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act.

26. How frequently do book-out transactions of the type described in the Brent Interpretation occur with respect to nonfinancial commodities? Please provide descriptions of any such transactions, and data with respect to their frequency. Are there any nonfinancial commodities or transactions to which the Brent Interpretation should not apply, either with respect to the forward contract exclusion from the definition of

"future delivery" or the forward contract exclusion from the swap definition, or both? Why or why not?

27. Should a minimum contract size for a transaction in a nonfinancial commodity (e.g., a tanker full of Brent oil) be required in order for the transaction to qualify as a forward contract under the Brent Interpretation with respect to the future delivery and swap definitions? Why or why not? If so, what standards should apply to determine such a minimum contract size? Should the Brent Interpretation for nonfinancial commodities with respect to the future delivery and swap definitions be limited to market participants that meet certain requirements? Why or why not? If so, does the "eligible commercial entity" definition in CEA section 1a(17)[98] provide an appropriate requirement? Why or why not? What other requirements, if any, should be imposed?

28. How often, and to what extent, do entities that do not regularly make or take delivery of the commodity in the ordinary course of their business engage in transactions that should qualify as forward contracts? Should such contracts qualify for the safe harbor provided by the Brent Interpretation? Why or why not? If so, how can it be demonstrated that the primary purpose of such transaction is to acquire or sell the physical commodity? Would including these transactions in the scope of the Brent Interpretation permit transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act? If so, could this concern be addressed by imposing conditions in order to qualify for the forward exclusion? What conditions, if any, would be appropriate?

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[98] 7 U.S.C. 1a(17).

29. Are "ring" or "daisy chain" markets for forward contracts, such as the 15-day Brent market, primarily used for commercial merchandising, or do they serve other purposes such as price discovery or risk management? Please explain in detail.

30. Should contracts in nonfinancial commodities that may qualify as forward contracts be permitted to trade on registered trading platforms such as DCMs or swap execution facilities ("SEFs")? If so, are additional guidance or rules necessary to determine whether contracts traded on such platforms are excluded from the CEA definition of "future delivery" and/or the swap definition? If so, please describe in detail such markets and explain what further guidance or rules would be appropriate? Should conditions be imposed with respect to the nature of the market participants or the percentage of transactions that must result in delivery over a specified measurement period, or both? If so, what conditions would be appropriate?

31. Should the Commissions provide guidance regarding the scope of the term "nonfinancial commodity" in the forward contract exclusion from the swap definition? If so, how and where should the Commissions draw the line between financial and nonfinancial commodities?

32. Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates? If so, please describe these commodities, and explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)? Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?

33. Are there other factors that should be considered in determining how to characterize forward contracts with embedded options with respect to nonfinancial commodities? If so, what factors should be considered? Do provisions in forward contracts with respect to nonfinancial commodities other than delivery and price contain embedded optionality? How do such provisions operate? Please provide a detailed analysis regarding how such provisions should be analyzed under the Dodd-Frank Act.

34. Is the analysis of forward contracts with embedded options in the 1985 Interpretation and the CFTC's Wright decision appropriately applied to transactions entered into after the effective date of the Dodd-Frank Act? Why or why not? If not, how should the analysis be modified?

35. How would the proposed interpretive guidance set forth in this section affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements, and ancillary services? Do these agreements, contracts, or transactions have optionality as to delivery? If so, should they – or any other agreement, contract, or transaction in a nonfinancial commodity that has optionality as to delivery – be excluded from the swap definition? If so, please provide a detailed analysis of such agreements, contracts, or transactions and how they can be distinguished from options that are to be regulated as swaps pursuant to the Dodd-Frank Act. To what extent are any such agreements, contracts, or transactions in the electric industry regulated by the Federal Energy Regulatory Commission ("FERC"), State regulatory authorities, regional transmission organizations ("RTOs"), independent system operators ("ISOs") or market monitoring units associated with RTOs or ISOs?

36. Is there any issue with respect to the treatment of commodity options that the Commissions have not addressed and that should be addressed as a definitional matter in this rulemaking?

37. Should the Commissions provide more detailed guidance regarding what constitutes a security forward? For instance, should the Commissions provide more guidance on what it means for a security forward to be "intended to be physically settled"? If so, what further guidance would be appropriate?

38. Should the Commissions provide more guidance regarding when forward sales of MBS in the TBA market would fall within the exclusion for sales of securities on a deferred settlement or delivery basis? Is there any more guidance the Commissions should provide regarding types of transactions that occur in the TBA market?

3. Consumer and Commercial Agreements, Contracts, and Transactions.

Commenters on the ANPR pointed out a number of areas in which a broad reading of the swap and security-based swap definitions could cover certain consumer and commercial arrangements that historically have not been considered swaps or security-based swaps. Examples of such instruments cited by commenters include evidences of indebtedness with a variable rate of interest;[99] commercial contracts containing acceleration, escalation, or indexation clauses;[100] agreements to acquire personal property or real property, or to obtain mortgages;[101] employment, lease, and

99 See Cleary Letter; Letter from Kenneth E. Auer, President and CEO, The Farm Credit Council, Sept. 20, 2010 ("Farm Credit Council Letter").

100 See Cleary Letter; White & Case Letter.

101 See White & Case Letter; Fannie Mae Letter.

service agreements, including those that contain contingent payment arrangements;[102] and consumer mortgage and utility rate caps.[103]

Consumers enter into various types of agreements, contracts, and transactions as part of their household and personal lives that may have attributes that could be viewed as falling within the swap or security-based swap definition. Similarly, businesses and other entities, whether or not for profit, also enter into agreements, contracts, and transactions as part of their operations relating to, among other things, acquisitions or sales of property (tangible and intangible), provisions of services, employment of individuals, and other matters that could be viewed as falling within the definitions.

The Commissions do not believe that Congress intended to include these types of customary consumer and commercial agreements, contracts, or transactions in the swap or security-based swap definition, to limit the types of persons that can enter into or engage in them, or to otherwise to subject these agreements, contracts, or transactions to the regulatory scheme for swaps and security-based swaps. The Commissions, therefore, are proposing the following interpretive guidance to assist consumers and businesses in understanding whether certain agreements, contracts, or transactions that they enter into would be regulated as swaps or security-based swaps.

With respect to consumers, the Commissions believe that the types of agreements, contracts, or transactions that should not be considered swaps or security-based swaps when entered into by consumers (natural persons or their agents) as principals primarily for personal, family, or household purposes, include:

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[102] See BlackRock Letter.

[103] See White & Case Letter; Deutsche Bank Letter.

- agreements, contracts, or transactions to acquire or lease real or personal property, to obtain a mortgage, to provide personal services, or to sell or assign rights owned by such consumer (such as intellectual property rights);

- agreements, contracts, or transactions to purchase products or services at a fixed price or a capped or collared price, at a future date or over a certain time period (such as agreements to purchase home heating fuel);[104]

- agreements, contracts, or transactions that provide for an interest rate cap or lock on a consumer loan or mortgage, where the benefit of the rate cap or lock is realized only if the loan or mortgage is made to the consumer; and

- consumer loans or mortgages with variable rates of interest or embedded interest rate options, including such loans with provisions for the rates to change upon certain events related to the consumer, such as a higher rate of interest following a default.

The types of commercial agreements, contracts, or transactions that involve customary business arrangements (whether or not involving a for-profit entity) and would not be considered swaps or security-based swaps under this proposed interpretive guidance include:

- employment contracts and retirement benefit arrangements;

[104] These agreements, contracts, or transactions involve physical delivery which is deferred for convenience or necessity and thus can be viewed as being akin to forward purchase agreements (sometimes with embedded options, in the case of those with price caps), which were discussed above in the context of the exclusion from the swap definition for forward contracts in nonfinancial commodities. While the CFTC traditionally has viewed forward contracts in nonfinancial commodities as limited to commercial merchandising transactions, the Commissions view consumer agreements, contracts, and transactions involving periodic or future purchases of consumer products and services, such as agreements to purchase energy commodities to heat or cool consumers' homes, as transactions that are not swaps.

- sales, servicing, or distribution arrangements;

- agreements, contracts, or transactions for the purpose of effecting a business combination transaction;[105]

- the purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory;

- warehouse lending arrangements in connection with building an inventory of assets in anticipation of a securitization of such assets (such as in a securitization of mortgages, student loans, or receivables);[106]

- mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables;

- fixed or variable interest rate commercial loans entered into by non-banks[107]; and

- commercial agreements, contracts, and transactions (including, but not limited to, leases, service contracts, and employment agreements) containing escalation clauses linked to an underlying commodity such as an interest rate or consumer price index.

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105 These business combination transactions include, for example, a reclassification, merger, consolidation, or transfer of assets as defined under the federal securities laws or any tender offer subject to section 13(e) and/or section 14(d) or (e) of the Exchange Act, 15 U.S.C. 78m(e) and/or 78n(d) or (e). These business combination agreements, contracts, or transactions can be contingent on the continued validity of representations and warranties and can contain earn-out provisions and contingent value rights.

106 The Commissions believe that such lending arrangements included in this category are traditional borrower/lender arrangements documented using, for example, a loan agreement or indenture, as opposed to a synthetic lending arrangement documented in the form of, for example, a TRS. The Commissions also note that securitization transaction agreements also may contain contingent obligations if the representations and warranties about the underlying assets are not satisfied.

107 See infra note 115 regarding identified banking products.

The Commissions intend this proposed interpretive guidance to allow consumers to engage in customary transactions relating to their households and personal or family activities without concern that such arrangements would be considered swaps or security-based swaps. Similarly, applying this guidance to customary commercial arrangements should allow commercial and non-profit entities to continue to operate their businesses and operations without significant disruption and ensure that the swap and security-based swap definitions are not read to include commercial and non-profit operations that historically have not been considered to involve swaps or security-based swaps.

The types of agreements, contracts, and transactions discussed above are not intended to be exhaustive of the customary consumer or commercial arrangements that should not be considered to be swaps or security-based swaps. There may be other, similar types of agreements, contracts, and transactions that also should not be considered to be swaps or security-based swaps. In determining whether similar types of agreements, contracts, and transactions entered into by consumers or commercial entities are swaps or security-based swaps, the Commissions intend to consider the characteristics and factors that are common to the consumer and commercial transactions listed above:

- they do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;
- they are not traded on an organized market or over-the-counter; and
- in the case of consumer arrangements, they:
  - involve an asset of which the consumer is the owner or beneficiary, or that the consumer is purchasing, or they involve a service provided, or to be provided, by or to the consumer, or

- in the case of commercial arrangements, they are entered into:

  - by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and

  - other than for speculative, hedging, or investment purposes.

Two of the key components reflected in these characteristics that distinguish these agreements, contracts, and transactions from swaps and security-based swaps are that: i) the payment provisions of the arrangements are not severable; and ii) the agreement, contract, or transaction is not traded on an organized market or over-the-counter – so that such arrangements would not involve risk-shifting arrangements with financial entities, as would be the case for swaps and security-based swaps.[108]

This proposed interpretive guidance is not intended to be the exclusive means for consumers and commercial or non-profit entities to determine whether their agreements, contracts, or transactions fall within the swap or security-based swap definition. If there is a type of agreement, contract, or transaction that is not enumerated above, or does not have all the characteristics and factors that are listed above (including new types of arrangements that may be developed in the future), but that a party to the agreement, contract, or transaction believes is not a swap or security-based swap, the Commissions

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108 There also are alternative regulatory regimes that have been enacted as part of the Dodd-Frank Act specifically to provide enhanced protections to consumers relating to various consumer transactions. See, e.g., the Consumer Financial Protection Act of 2010, Pub L. 111-203, tit. X, 124 Stat. 1376 (July 21, 2010) (establishing the Bureau of Consumer Financial Protection to regulate a broad category of consumer products and amending certain laws under the jurisdiction of the Federal Trade Commission); the Mortgage Reform and Anti-Predatory Lending Act, Pub L. 111-203, tit. XIV, 124 Stat. 1376 (July 21, 2010) (amending existing laws, and adding new provisions, related to certain mortgages). Some of these agreements, contracts, or transactions are subject to regulation by the Federal Trade Commission and other federal financial regulators and state regulators.

invite such party to seek an interpretation from the Commissions as to whether the agreement, contract, or transaction is a swap or security-based swap.

Request for Comment:

39. Is interpretive guidance of the type proposed in this section necessary with respect to the application of the swap and security-based swap definitions to certain consumer and commercial agreements, contracts, or transactions?

40. Is the interpretive guidance proposed in this section useful, appropriate, and sufficient for persons to consider when evaluating whether agreements, contracts, or transactions of the types described in this section fall within the swap or security-based swap definition?

41. In particular, are the listed characteristics and factors for consumer transactions and for commercial transactions appropriate for purposes of evaluating whether agreements, contracts, or transactions fall within the swap or security-based swap definition? If not, what characteristics or factors should be included or excluded, and why? Are any of the characteristics or factors too narrow or too broad? If so, how should the listed characteristics and factors be modified, and why?

42. Is a joint interpretation as provided for in section 712(d)(4) of the Dodd-Frank Act, pursuant to the proposed process discussed in part VI below, an appropriate means of addressing any further interpretive questions?

43. Does the interpretive guidance proposed in this section sufficiently enumerate the types of consumer and commercial agreements, contracts, or transactions that should not be considered swaps or security-based swaps? If not, please provide

details of other types of such agreements, contracts, or transactions and an explanation of the reasons why the definitions should not apply to them.

44. Is the treatment of consumer or commercial contracts containing payment arrangements sufficiently clear? For example, should the interpretive guidance expressly address any other specific types of contracts, such as installment sales contracts, financings used in normal business operations (such as receivables financings), pensions and other post-retirement benefits, contracts relating to the performance of a service, standby liquidity agreements, indemnification agreements, reimbursement agreements, or affiliate guarantees? Why or why not?

45. Is the treatment of purchases, sales, leases, or transfers of equipment and inventory sufficiently flexible to not interfere with ordinary business operations? As an alternative, should the guidance expressly cover the purchase, sale, lease, or transfer of assets (excluding financial assets) that are anticipated to be owned, leased, licensed, produced, manufactured, processed, or merchandized by one of the parties or an affiliate? Why or why not?

4. Loan Participations.

Two commenters inquired whether loan participations fall within the scope of the swap and security-based swap definitions.[109] According to these commenters, loan participations arise when a lender transfers the economic risks and benefits of all or a portion of a loan it has entered into with a borrower to another party as an alternative or

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[109] See Letter from R. Bram Smith, Executive Director, The Loan Syndications and Trading Association, Jan. 25, 2011 ("January LSTA Letter") and letter from Elliot Ganz, General Counsel, The Loan Syndications and Trading Association, Mar. 1, 2011 ("March LSTA Letter, and collectively with the January LSTA Letter, "LSTA Letters"); Letter from Clare Dawson, Managing Director, Loan Market Association, Feb. 23, 2011.

precursor to assigning to such person the loan or an interest in the loan.[110] Two types of loan participations are offered in the market today according to these commenters: LSTA-style participations and LMA-style participations.[111] An LSTA-style participation "specifically provides that the participation is intended by the parties to be treated as a sale by the grantor and a purchase by the participant" and "is intended to effect a 'true sale' of the loan from the grantor to the participant and put the participant's beneficial ownership interest in the loan beyond the reach of the grantor's bankruptcy estate."[112] By contrast, an LMA-style participation, while not effecting a sale, "creates a current debtor-creditor relationship between the grantor and the participant under which a future ownership interest is conveyed."[113] Neither type of loan participation is a "synthetic" transaction according to the March LSTA letter because "they are merely transfers of cash loan positions" and "[t]he ratio of underlying loan to participation is always one-to-one."

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110 See Loan Market Association, "Guide to Syndicated Loans," section 6.2.5 ("Risk participation may be provided by a new lender as an interim measure before it takes full transfer of a loan."), available at http://www.lma.eu.com/uploads/files/Introductory_Guides/Guide_to_Par_Syndicated_Loans.pdf.

111 The LSTA is The Loan Syndications and Trading Association. The LMA is the Loan Market Association.

112 See January LSTA Letter (citation omitted).

113 See LSTA Letters. But see Jon Kibbe, Julia Lu and Carl Winkworth, Richards Kibbe & Orbe, LLP, "Dodd-Frank Crosses the Pond: Unintended Consequences for LMA-Style Loan Participations?," 3 (Nov. 12, 2010) ("The grantor of an LMA-style participation does not grant an ownership interest in the loan to the participant.") ("LMA-Style LP Memo"), available at http://www.rkollp.com/assets/attachments/Dodd-Frank%20Crosses%20the%20Pond%20-%20Unintended%20Consequences%20for%20LMA-Style%20Loan%20Participations.pdf.

Depending on the facts and circumstances, a loan participation may be a security under the federal securities laws and, as such, the loan participation would be excluded from the definition of swap as the purchase and sale of a security on a fixed or contingent basis.[114] In addition, depending on the facts and circumstances, a loan participation may be an identified banking product and, as such, would be excluded from CFTC jurisdiction and from the "security-based swap" and "security-based swap agreement" definitions.[115]

The Commissions do not interpret the swap and security-based swap definitions to include loan participations in which the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan and the loan participations are "true participations" (the participant acquires a beneficial ownership interest in the underlying loans).[116]

Request for Comment:

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114 See CEA sections 1a(47)(B)(v) and (vi), 7 U.S.C. 1a(47)(b)(v) and (vi), as amended by section 721(a)(21) of the Dodd-Frank Act (excluding purchases and sales of a security on a fixed or contingent basis, respectively from the swap definition).

115 See section 403(a) of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27a(a), as amended by section 725(g)(2) of the Dodd-Frank Act (providing that, under certain circumstances, the CEA shall not apply to, and the CFTC shall not exercise regulatory authority over, identified banking products, and the definitions of the terms "security-based swap" and "security-based swap agreement" shall not include identified banking products).

116 See generally Richard M. Gray and Suhrud Mehta, Milbank Tweed Hadley & McCloy LLP, "US and UK compared Fundamental differences remain between the markets. But is it worth considering using a New York participation agreement in an English deal?," International Financial Law Review (Oct. 1, 2009) (discussing differences between New York and English participation markets and features distinguishing true participations from financings), available at http://www.milbank.com/NR/rdonlyres/B95C06AD-C3CA-44C9-8433-B6021C4455C9/0/102009_IFLR_USandUKcompared_RGray_SMehta.pdf; Cleary, Gottlieb, Steen & Hamilton, Memorandum for the Financial Accounting Standards Board, Re: Participations (June 14, 2004) (discussing, among other things, what a "good" or "true" participation is under the Uniform Commercial Code, the Bankruptcy Code, case law, and other authority), available at http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175817895286&blobheader=application%2Fpdf.

46. Should any of the enumerated agreements, contracts, or transactions be considered swaps or security-based swaps whether in general or in certain narrow circumstances? If so, which ones and why? In particular, how are loan participations similar to and different from loan TRS? Does the proposed guidance adequately distinguish between loan participations similar to and different from loan TRS?

47. Does the Commissions' proposed interpretive guidance regarding loan participations exclude from the swap or security-based swap definitions agreements, contracts, or transactions that are swaps or security-based swaps? If so, please describe such agreements, contracts, or transactions and suggested adjustments to the proposed guidance to capture such agreements, contracts, or transactions as swaps or security-based swaps.

48. Is the Commissions' proposed interpretive guidance regarding loan participations as not falling within the swap and security-based swap definitions appropriate? Why or why not? Should the Commissions provide further guidance on what constitutes an "ownership interest" in the loan underlying a loan participation? If so, what should such guidance provide?

49. Do all loan participations convey a current or future direct or indirect ownership interest from the grantor to the participant or sub-participant? If so, what indicia of ownership are conveyed and when, particularly in LMA-style loan participations? Do loan participations use leverage? If so, how?

50. Are any swaps or security-based swaps partly or fully defeased?

51. Should the Commissions provide further guidance regarding the scope of "true participation?" If so, how should the Commissions delineate the scope thereof?

C. Proposed Rules and Interpretive Guidance Regarding Certain Transactions Within the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap."

1. In General.

In light of provisions in the Dodd-Frank Act that specifically address certain foreign exchange products, the Commissions are proposing rules to clarify the status of products such as foreign exchange forwards, foreign exchange swaps, foreign exchange options, non-deliverable forwards involving foreign exchange ("NDFs"), and cross-currency swaps. The Commissions also are proposing a rule to clarify the status of FRAs and providing interpretive guidance regarding: i) combinations and permutations of, or options on, swaps or security-based swaps; and ii) contracts for differences ("CFDs").

Proposed rule 1.3(xxx)(2) under the CEA and proposed rule 3a69-2 under the Exchange Act would explicitly define the term "swap" to include certain foreign exchange-related products and FRAs unless such products would be excluded by the list of exclusions in subparagraph (B) of the swap definition.[117] In proposing these rules, the Commissions do not mean to suggest that any other agreement, contract, or transaction not mentioned in the proposed rules or specifically enumerated in the statutory definition would not be covered by the swap or security-based swap definitions in the Dodd-Frank Act.

[117] See CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B).

2. Foreign Exchange Products.

a) Foreign Exchange Products Subject to the Secretary's Swap Determination: Foreign Exchange Forwards and Foreign Exchange Swaps.

The Dodd-Frank Act provides that "foreign exchange forwards" and "foreign exchange swaps" shall be considered swaps under the swap definition unless the Secretary of the Treasury ("Secretary") issues a written determination that either foreign exchange swaps, foreign exchange forwards, or both: i) should not be regulated as swaps; and ii) are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the CFTC pursuant to section 721(c) of the Dodd-Frank Act.[118] A foreign exchange forward is defined as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."[119] A foreign exchange swap, in turn, is defined as:

> a transaction that solely involves—
> (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and
> (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange.[120]

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118 See CEA section 1a(47)(E)(i), 7 U.S.C. 1a(47)(E)(i). The Secretary has issued a request for comment about whether an exclusion from the swap definition for foreign exchange swaps, foreign exchange forwards, or both, is warranted, and on the application of the statutory factors that the Secretary must consider in making a determination regarding whether to exclude these products. See Determinations of Foreign Exchange Swaps and Forwards, 75 FR 66829, Oct. 29, 2010.

119 See CEA section 1a(24), 7 U.S.C. 1a(24).

120 See CEA section 1a(25), 7 U.S.C. 1a(25).

Under the Dodd-Frank Act, if foreign exchange forwards or foreign exchange swaps are no longer considered swaps due to a determination by the Secretary, nevertheless, certain provisions of the CEA added by the Dodd-Frank Act would continue to apply to such transactions. Specifically, those transactions still would be subject to certain requirements for reporting swaps, and swap dealers and major swap participants engaging in such transactions still would be subject to certain business conduct standards.[121]

The Commissions are proposing to provide greater clarity by explicitly defining by rule the term "swap" to include foreign exchange forwards and foreign exchange swaps (as those terms are defined in the CEA).[122] The proposed rules would incorporate the provision of the Dodd-Frank Act that, if the Secretary issues the written determination described above, foreign exchange forwards and foreign exchange swaps would no longer be considered swaps. The proposed rules also would reflect the continuing applicability of certain reporting requirements and business conduct standards in the event that the Secretary makes such a determination.[123]

b) Foreign Exchange Products Not Subject to the Secretary's Swap Determination.

The Commissions also are proposing rules to provide clarity that a determination by the Secretary that foreign exchange forwards or foreign exchange swaps, or both,

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121 See, e.g., CEA sections 1a(47)(E)(iii) and (iv), 7 U.S.C. 1a(47)(E)(iii) and (iv) (reporting and business conduct standards, respectively).

122 As noted above, the proposed rules provide that foreign exchange forwards and forward exchange swaps would not be swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

123 The exclusion of foreign exchange forwards and foreign exchange swaps would become effective upon the Secretary's submission of the determination to the appropriate Congressional Committees. See CEA section 1a(47)(E)(ii), 7 U.S.C. 1a(46)(E)(ii).

should not be regulated as swaps would not affect other products involving foreign currency, such as foreign currency options, NDFs, and cross-currency swaps. The Commissions are proposing rules to explicitly define the term "swap" to include such products, irrespective of whether the Secretary makes a determination to exempt foreign exchange forwards or foreign exchange swaps.[124]

i) Foreign Currency Options.[125]

As discussed above, the statutory swap definition includes options, and it expressly enumerates foreign currency options. It encompasses any agreement, contract, or transaction:

> (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest <u>or other rates, currencies,</u> commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind.[126]

Foreign exchange options traded on a national securities exchange ("NSE"), however, are securities under the federal securities laws and not swaps or security-based swaps.[127]

Any determination by the Secretary, discussed above, that foreign exchange forwards or foreign exchange swaps should not be regulated as swaps would not impact foreign currency options because a foreign currency option is neither a foreign exchange

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124 As discussed above, however, the proposed rules provide that none of the products discussed in this section (b) would be swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

125 This discussion is not intended to address, and has no bearing on, the CFTC's jurisdiction over foreign currency options in other contexts. <u>See, e.g.</u>, CEA sections 2(c)(2)(A)(iii) and 2(c)(2)(B)-(C), 7 U.S.C. 2(c)(2)(A)(iii) and 2(c)(2)(B)-(C) (off-exchange options in foreign currency offered or entered into with retail customers).

126 <u>See</u> CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i) (emphasis added).

127 <u>See</u> CEA section 1a(47)(B)(iv), 7 U.S.C. 1a(47)(B)(iv).

swap nor a foreign exchange forward, as those terms are defined in the CEA. Consequently, the Commissions are proposing rules to provide clarity by explicitly defining the term "swap" to include foreign currency options (other than foreign currency options traded on an NSE).[128] The proposed rules also would clarify that foreign currency options are not foreign exchange forwards or foreign exchange swaps under the CEA.

ii) Non-Deliverable Forward Contracts Involving Foreign Exchange.

An NDF generally is similar to a forward foreign exchange contract,[129] except that at maturity, the NDF does not require physical delivery of currencies and is typically settled in U.S. dollars. The other currency, usually an emerging market currency subject to capital controls, is therefore said to be "nondeliverable."[130] If the spot market exchange rate on the settlement date is greater (in foreign currency per dollar terms) than the previously agreed forward exchange rate, the party to the contract that is long the

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128 The proposed rules would treat the terms foreign currency options, currency options, foreign exchange options, and foreign exchange rate options as synonymous. Moreover, for purposes of the proposed rules, foreign currency options include options to enter into or terminate, or that otherwise operate on, a foreign exchange swap or foreign exchange forward or on the terms thereof. As discussed above, foreign exchange options traded on an NSE are securities and therefore not addressed in the proposed rules.

129 A deliverable forward foreign exchange contract is an obligation to buy or sell a specific currency on a future settlement date at a fixed price set on the trade date. See Laura Lipscomb, "Federal Reserve Bank of New York, An Overview of Non-Deliverable Foreign Exchange Forward Markets," 1 (May 2005) (citation omitted) ("Fed NDF Overview").

130 See id. at 1-2 (citation omitted).

emerging market currency must pay its counterparty the difference between the contracted forward price and the spot market rate, multiplied by the notional amount.[131]

NDFs are not expressly enumerated in the swap definition, but they satisfy clause (A)(iii) of the definition because they provide for a future (executory) payment based on an exchange rate, which is an "interest or other rate[]" within the meaning of clause (A)(iii) of the swap definition.[132] Each party to an NDF transfers to its counterparty the risk of the exchange rate moving against the counterparty, thus satisfying the requirement that there be a transfer of financial risk associated with a future change in rate. This financial risk transfer in the context of an NDF is not accompanied by a transfer of an ownership interest in any asset or liability. Thus, an NDF is a swap under clause (A)(iii) of the swap definition.[133]

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131 See id. at 2. Being long the emerging market currency means that the holder of the NDF contract is the "buyer" of the emerging market currency and the "seller" of dollars. Conversely, if the emerging market currency appreciates relative to the previously agreed forward rate, the holder of the contract that is short the emerging market currency must pay its counterparty the difference between the spot market rate and the contracted forward price, multiplied by the notional amount. See id. at 2, n.4.

132 See CEA section 1a(47)(A)(iii), 7 U.S.C. 1a(47)(A)(iii) (providing that a swap is an agreement, contract, or transaction "that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred . . . .").

133 It appears that at least some market participants view NDFs as swaps today. See, e.g., Credit Suisse, "Non-Deliverable Forwards," at 1 (characterizing NDFs as "a derivative instrument for hedging . . . exchange-rate risk" in the absence of a forwards market), available at https://www.credit-suisse.com/ch/unternehmen/kmugrossunternehmen/doc/nondeliverable_forward_en.pdf; Association of Corporate Treasurers, "Glossary of Terms" (defining an NDF as "[a] foreign currency financial derivative contract"), available at http://www.treasurers.org/glossary/N#Non-deliverableforward. Thus, NDFs also may

As discussed above, the Secretary may determine that foreign exchange swaps or foreign exchange forwards should not be regulated as swaps. The outcome of the Secretary's determination would not impact NDFs, however, because NDFs (like foreign currency options) do not meet the definitions of the terms foreign exchange forward or foreign exchange swap set forth in the CEA. NDFs do not involve an "exchange" of two different currencies (an element of the definition of both a foreign exchange forward and a foreign exchange swap); instead, they are settled by payment in one currency (usually U.S. dollars).

Notwithstanding their "forward" label, NDFs do not fall within the forward contract exclusion of the swap definition. Currency is outside the scope of the forward contract exclusion for nonfinancial commodities. Nor have NDFs traditionally been considered commercial merchandising transactions. Rather, the NDF markets appear to be driven in large part by speculation[134] and hedging,[135] which features are more characteristic of swap markets than forward markets.

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fall within clause (A)(iv) of the swap definition as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." See CEA section 1a(47)(A)(iv), 7 U.S.C. 1a(47)(A)(iv). Cf. CFTC rule 35.1(b)(1)(i), 17 CFR 35.1(b)(1)(i) (providing that the definition of "swap agreement" includes a "forward foreign exchange agreement," without reference to convertibility or delivery).

134 See "Fed NDF Overview," supra note 129, at 5 ("[E]stimates vary but many major market participants estimate as much as 60 to 80 percent of NDF volume is generated by speculative interest, noting growing participation from international hedge funds.") and 4 ("[D]ealers note that much of the volume in Chinese yuan NDFs is generated by speculative positioning based on expectations for an alteration in China's current, basically fixed exchange rate.") (italics in original).

135 See id. at 4 (noting that "[much of the] Korean won NDF volume[,] . . . estimated to be the largest of any currency, . . . is estimated to originate with international investment portfolio managers hedging the currency risk associated with their onshore investments").

Based on the foregoing considerations, the Commissions are proposing to provide greater clarity by explicitly defining the term "swap" to include NDFs. The proposed rules also would clarify that NDFs are not foreign exchange forwards or foreign exchange swaps as those terms are defined in the CEA.

iii) Currency Swaps and Cross-Currency Swaps.

A currency swap[136] and a cross-currency swap[137] each generally can be described as a swap in which the fixed legs or floating legs based on various interest rates are exchanged in different currencies. Such swaps can be used to reduce borrowing costs, to hedge currency exposure, and to create synthetic assets[138] and are viewed as an important

136 A swap that exchanges a fixed rate against a fixed rate is known as a currency swap. See Federal Reserve System, "Trading and Capital-Markets Activities Manual," section .4335.1 (Jan. 2009).

137 Cross-currency swaps with a fixed leg based on one rate and a floating leg based on another rate, where the two rates are denominated in different currencies, are generally referred to as cross-currency coupon swaps, while those with a floating leg based on one rate and another floating leg based on a different rate are known as cross-currency basis swaps. Id. Cross-currency swaps also include annuity swaps and amortizing swaps. In cross-currency annuity swaps, level cash flows in different currencies are exchanged with no exchange of principal; annuity swaps are priced such that the level payment cash flows in each currency have the same net present value at the inception of the transaction. An amortizing cross-currency swap is structured with a declining principal schedule, usually designed to match that of an amortizing asset or liability. Id.

See also Derivatives ONE, "Cross Currency Swap Valuation" ("A cross currency swap is swap of an interest rate in one currency for an interest rate payment in another currency . . . . This could be considered an interest rate swap with a currency component."), available at http://www.derivativesone.com/cross-currency-swap-valuation/; Financial Accounting Standards Board, "Examples Illustrating Application of FASB Statement No. 138," Accounting for Certain Derivative Instruments and Certain Hedging Activities, section 2, Example 1, at 3 ("The company designates the cross-currency swap as a fair value hedge of the changes in the fair value of the loan due to both interest and exchange rates."), available at http://www.fasb.org/derivatives/examples.pdf.

138 BMO Capital Markets, "Cross Currency Swaps," available at http://www.bmocm.com/products/marketrisk/intrderiv/cross/default.aspx.

tool, given that they can be used to hedge currency and interest rate risk in a single transaction.

Currency swaps and cross-currency swaps are not foreign exchange swaps as defined in the CEA because, although they may involve an exchange of foreign currencies, they also require contingent or variable payments in different currencies. Because the CEA defines a foreign exchange swap as a swap that "solely" involves an initial exchange of currencies and a reversal thereof at a later date, subject to certain parameters, currency swaps and cross-currency swaps would not be foreign exchange swaps. Similarly, currency swaps and cross-currency swaps are not foreign exchange forwards because foreign exchange forwards "solely" involve an initial exchange of currencies, subject to certain parameters, while currency swaps and cross-currency swaps contain additional elements, as discussed above.

Currency swaps are expressly enumerated in the statutory definition of the term "swap."[139] Cross-currency swaps, however, are not.[140] Accordingly, based on the foregoing considerations, the Commissions are proposing rules to provide greater clarity by explicitly defining the term "swap" to include cross-currency swaps. The proposed rules also would clarify that neither currency swaps nor cross-currency swaps are foreign exchange forwards or foreign exchange swaps as those terms are defined in the CEA.

Request for Comment:

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139 See CEA section 1a(47)(A)(iii)(VII), 7 U.S.C. 1a(47)(A)(iii)(VII).

140 Clause (A)(iii) of the swap definition expressly refers to a cross-currency rate swap. See CEA section 1a(47)(A)(iii)(V), 7 U.S.C. 1a(47)(A)(iii)(V). Although the swap industry appears to use the term "cross-currency swap," rather than "cross-currency rate swap" (the term used in CEA section 1a(47)(A)(iii)(V)), the Commissions interpret these terms as synonymous.

52. Should the proposed rules explicitly define the term "swap" to include foreign exchange forwards and foreign exchange swaps, unless the Secretary determines to exempt them? Should the proposed rules clarify that, if the Secretary determines to exempt foreign exchange swaps or foreign exchange forwards, those transactions remain subject to certain reporting requirements, and swap dealers and major swap participants entering into such transactions remain subject to certain business conduct standards, imposed by Title VII and CFTC regulations promulgated thereunder? Why or why not?

53. Should the proposed rules explicitly define the term "swap" to include foreign currency options and clarify that foreign currency options are not foreign exchange forwards or foreign exchange swaps? Why or why not? Should the terms foreign currency options, currency options, foreign exchange options, and foreign exchange rate options be interpreted as synonymous? Why or why not?

54. Should the proposed rules explicitly define the term "swap" to include NDFs and clarify that NDFs are not foreign exchange forwards or foreign exchange swaps? Why or why not?

55. Should the proposed rules explicitly define the term "swap" to include cross-currency swaps as swaps and clarify that currency swaps and cross-currency swaps are not foreign exchange forwards or foreign exchange swaps? Why or why not? Should the terms cross-currency swap and cross-currency rate swap be interpreted as synonymous? Why or why not?

56. Is additional detail needed within the proposed rules regarding foreign exchange-related products to provide greater clarity regarding the specific products listed in the proposed rules? If so, what additional detail would be necessary?

3. Forward Rate Agreements.

In general, the Commissions understand an FRA to be an over-the-counter contract for a single cash payment, due on the settlement date of a trade, based on a spot rate (determined pursuant to a method agreed upon by the parties) and a prespecified forward rate. The single cash payment is equal to the product of the present value (discounted from a specified future date to the settlement date of the trade) of the difference between the forward rate and the spot rate on the settlement date multiplied by the notional amount. The notional amount itself is not exchanged.[141]

An FRA provides for the future (executory) payment based on the transfer of interest rate risk between the parties as opposed to transferring an ownership interest in

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141 See generally "Trading and Capital-Markets Activities Manual," supra note 136, section 4315.1 ("For example, in a six-against-nine-month (6x9) FRA, the parties agree to a three-month rate that is to be netted in six months' time against the prevailing three-month reference rate, typically LIBOR. At settlement (after six months), the present value of the net interest rate (the difference between the spot and the contracted rate) is multiplied by the notional principal amount to determine the amount of the cash exchanged between the parties . . . . If the spot rate is higher than the contracted rate, the seller agrees to pay the buyer the differences between the prespecified forward rate and the spot rate prevailing at maturity, multiplied by a notional principal amount. If the spot rate is lower than the forward rate, the buyer pays the seller.").

any asset or liability.[142] Thus, the Commissions believe that an FRA satisfies clause (A)(iii) of the swap definition.[143]

Notwithstanding their "forward" label, FRAs do not fall within the forward contract exclusion from the swap definition. FRAs do not involve nonfinancial commodities and thus are outside the scope of the forward contract exclusion. Nor is an FRA a commercial merchandising transaction, as there is no physical product to be delivered in an FRA.[144] Accordingly, the Commissions believe that the forward contract exclusion from the swap definition for nonfinancial commodities does not apply to FRAs.[145]

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142 It appears that at least some in the trade view FRAs as swaps today. See, e.g., The Globecon Group, Ltd., "Derivatives Engineering: A Guide to Structuring, Pricing and Marketing Derivatives," 45 (McGraw-Hill 1995) ("An FRA is simply a one-period interest-rate swap."); DerivActiv, Glossary of Financial Derivatives Terms ("A swap is . . . a strip of FRAs."), available at http://www.derivactiv.com/definitions.aspx?search=forward+rate+agreements. Cf. Don M. Chance, et. al, "Derivatives in Portfolio Management," 29 (AIMR 1998) ("[An FRA] involves one specific payment and is basically a one-date swap (in the sense that a swap is a combination of FRAs[,] with some variations)."). Thus, FRAs also may fall within clause (A)(iv) of the swap definition, as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." See CEA section 1a(47)(a)(iv), 7 U.S.C. 1a(47)(a)(iv).

143 See CEA section 1a(47)(A)(iii); 7 U.S.C. 1a(47)(A)(iii). CFTC regulations have defined FRAs as swap agreements. See CFTC rule 35.1(b)(1)(i), 17 CFR 35.1(b)(1)(i); Exemption for Certain Swap Agreements, 58 FR 5587, Jan. 22, 1993. The CFTC recently has proposed to repeal that rule in light of the enactment of Title VII of the Dodd-Frank Act. See Commodity Options and Agricultural Swaps, supra note 78.

144 See Regulation of Hybrid and Related Instruments, 52 FR 47022, 47028, Dec. 11, 1987 (stating "[FRAs] do not possess all of the characteristics of forward contracts heretofore delineated by the [CFTC]").

145 Current European Union law includes FRAs in the definition of "financial instruments." See Markets in Financial Instruments Directive (MiFID), "Directive 2004/39/EC of the European Parliament and of the Council," Annex I(C), 4, 5, 10 (Apr. 21, 2004), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0039:20070921:EN:PDF. A European Commission legislative proposal on derivatives, central clearing, and trade repositories applies to FRAs that are traded over-the-counter and, thus, would

Based on the foregoing considerations, the Commissions are proposing rules to provide greater clarity by explicitly defining the term "swap" to include FRAs. As with the foreign exchange-related products discussed above, the proposed rules provide that FRAs would not be swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

Request for Comment:

57. Is the description of FRAs accurate? If not, please provide a detailed description of FRAs. Are there various types of FRAs? If so, please provide an explanation of their characteristics and how they differ.

58. What types of market participants use FRAs, and for what purposes? What market (spot) and fixed rates are used in FRAs, and how are those rates determined, or on what are those rates based?

59. Should the proposed rules explicitly define the term "swap" to include FRAs? Why or why not?

60. Should the proposed rules provide a more detailed description of what FRAs are? Why or why not? If so, please explain what additional language regarding FRAs should be included in the proposed rules.

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subject such transactions to mandatory clearing, reporting and other regulatory requirements. See Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, tit. I, art. 1(1), COM(2010) 484/5 (Sept. 15, 2010), available at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf.

4. Combinations and Permutations of, or Options on, Swaps and Security-Based Swaps.

Clause (A)(vi) of the swap definition provides that "any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v)" of the definition is a swap or security-based swap.[146] As a result, clause (A)(vi) means, for example, that an option on a swap or security-based swap (commonly known as a "swaption") would itself be a swap or security-based swap, respectively. The Commissions also interpret clause (A)(vi) to mean that a "forward swap" would itself be a swap or security-based swap, respectively.[147]

Request for Comment:

61. Is additional guidance regarding swaptions, necessary? Why or why not? If so, please provide a detailed explanation of what additional guidance would be necessary.

62. Is the Commissions' description of forward swaps accurate? Why or why not? If not, please provide a detailed explanation of why the description is inaccurate. Is additional guidance regarding forward swaps necessary? Why or why not? If so, please provide a detailed explanation of what additional guidance would be necessary.

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146 See CEA section 1a(47)(vi), 7 U.S.C. 1a(47)(vi).

147 Forward swaps are also commonly known as forward start swaps, or deferred or delayed start swaps. A forward swap can involve two offsetting swaps that both start immediately, but one of which ends on the deferred start date of the forward swap itself. For example, if a counterparty wants to hedge its risk for four years, starting one year from today, it could enter into a one-year swap and a five-year swap, which would partially offset to create a four-year swap, starting one year forward. A forward swap also can involve a contract to enter into a swap or security-based swap at a future date or with a deferred start date. A forward swap is not a nonfinancial commodity forward contract or security forward, both of which are excluded from the swap definition and discussed elsewhere in this release.

63. Is additional guidance regarding other combinations or permutations of swaps or security-based swaps necessary? Why or why not? If so, please provide a detailed description of any particular agreement, contract, or transaction, including the purposes for which it is used and the market participants that use it, and what additional guidance would be necessary.

5. Contracts for Differences.

The Commissions have received inquiries over the years regarding the treatment of CFDs under the CEA and the federal securities laws. A CFD generally is an agreement to exchange the difference in value of an underlying asset between the time at which a CFD position is established and the time at which it is terminated.[148] If the value increases, the seller pays the buyer the difference; if the value decreases, the buyer pays the seller the difference. CFDs can be traded on a number of products, including treasuries, foreign exchange rates, commodities, equities, and stock indexes. Equity CFDs closely mimic the purchase of actual shares. The buyer of an equity CFD receives

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148 See Ontario Securities Commission, Staff Notice 91-702, "Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario," at part IV.1 (defining a CFD as "a derivative product that allows an investor to obtain economic exposure (for speculative, investment or hedging purposes) to an underlying asset . . . such as a share, index, market sector, currency or commodity, without acquiring ownership of the underlying asset"), available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/sn_20091030_91-702_cdf.pdf (Oct. 30, 2009); Financial Services Authority, Consultation Paper 7/20, "Disclosure of Contracts for Difference - Consultation and draft Handbook text," at part 2.2 (defining a CFD on a share as "a derivative product that gives the holder an economic exposure, which can be long or short, to the change in price of a specific share over the life of the contract"), available at http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf (Nov. 2007).

cash dividends and participates in stock splits.[149] In the case of a long position, a dividend adjustment is credited to the client's account. In the case of a short position, a dividend adjustment is debited from the client's account. CFDs generally are traded over-the-counter (though they also are traded on the Australian Securities Exchange) in a number of countries outside the United States.

CFDs, unless otherwise excluded, may fall within the scope of the swap and security-based swap definitions.[150] Whether a CFD is a swap or security-based swap will depend on the underlying product of that particular CFD transaction. Because CFDs are highly variable and a CFD can contain a variety of elements that would affect its characterization, the Commissions believe that market participants will need to analyze the characteristics of any particular CFD in order to determine whether it is a swap or a security-based swap. Therefore, the Commissions are not proposing rules or additional interpretive guidance at this time regarding CFDs.

Request for Comment:

64. Should the Commissions provide additional guidance regarding CFDs? Why or why not? If so, please provide a detailed description of any particular CFD and what additional guidance would be necessary.

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149 See, e.g., Int'l Swaps and Derivatives Ass'n, "2002 ISDA Equity Derivatives Definitions," art. 10 (Dividends) and 11 (Adjustments and Modifications Affecting Indices, Shares and Transactions).

150 In some cases, depending on the facts and circumstances, the SEC may determine that a particular CFD on an equity security, for example, should be characterized as constituting a purchase or sale of the underlying equity security and, therefore, be subject to the requirements of the federal securities laws applicable to such purchases or sales.

D. Certain Interpretive Issues.

1. Agreements, Contracts, or Transactions That May Be Called, or Documented Using Form Contracts Typically Used for, Swaps or Security-Based Swaps.

The Commissions are aware that individuals and companies may generally use the term "swap" to refer to certain of their agreements, contracts, or transactions. For example, the term "swap" may be used to refer to an agreement to exchange real or personal property between the parties. Or, two companies that produce fungible products may use the term "swap" to refer to an agreement to perform each other's delivery obligations – for example, if one company must deliver the product in California and the other must deliver the same product in New York, they may use the term "swap" to refer to an agreement that each company will perform the other's delivery obligation.

The name or label that the parties use to refer to a particular agreement, contract, or transaction is not determinative of whether it is a swap or security-based swap.[151] Also, it may not be relevant whether the agreement, contract, or transaction is documented using an industry standard form agreement that is typically used for swaps and security-based swaps.[152] Instead, the relevant question is whether the agreement,

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151 See, e.g., Haekel v. Refco, 2000 WL 1460078, at *4 (CFTC Sept. 29, 2000) ("[T]he labels that parties apply to their transactions are not necessarily controlling"); Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) (stating that the purpose of the securities laws is "to regulate investments, in whatever form they are made and by whatever name they are called") (emphasis in original).

152 The CFTC consistently has found that the form of a transaction is not dispositive in determining its nature. See, e.g., Grain Land, supra note 61, at *16 (CFTC Nov. 25, 2003) (holding that contract substance is entitled to at least as much weight as form); In the Matter of First Nat'l Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,974 (CFTC Aug. 7, 1985) ("When instruments have been determined to constitute the functional equivalent of futures contracts neither we nor the courts have hesitated to look behind whatever self-serving labels the instruments might bear."); Stovall, supra note 63 (holding that the CFTC "will not hesitate to look behind

contract, or transaction falls within the definition of the terms "swap" or "security-based swap" (as further interpreted pursuant to the guidance proposed herein) based on its terms and other characteristics. Even if one effect of an agreement is to reduce the risk faced by the parties (e.g., the "swap" of physical delivery obligations described above may reduce the risk of non-delivery), the agreement is not a swap or security-based swap unless it otherwise meets one of the statutory definitions, as further defined by the Commissions. Similarly, the fact that the parties use another name to refer to a swap or security-based swap would not be relevant in determining whether the agreement, contract, or transaction is a swap or security-based swap as those terms are defined in the CEA and the Exchange Act and the rules and regulations thereunder.

Request for Comment:

65. What agreements, contracts, or transactions that are not swaps or security-based swaps are documented using industry standard form agreements that are typically used for swaps and security-based swaps? Please provide examples of such agreements, contracts, or transactions and details regarding their documentation, including why industry standard form agreements typically used for swaps and security-based swaps are used.

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whatever label the parties may give to the instrument"). Likewise, the form of a transaction is not dispositive in determining whether an agreement, contract, or transaction falls within the regulatory regime for securities. See SEC v. Merch. Capital, LLC, 483 F.3d 747, 755 (11th Cir. 2007) ("The Supreme Court has repeatedly emphasized that economic reality is to govern over form and that the definitions of the various types of securities should not hinge on exact and literal tests.") (quoting Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981)); Robinson v. Glynn, 349 F.3d 166, 170 (4th Cir. 2003) ("What matters more than the form of an investment scheme is the 'economic reality' that it represents . . . .") (internal citation omitted); Caiola v. Citibank, N.A., New York, 295 F.3d 312, 325 (2d Cir. 2002) (quoting United Housing Foundation v. Foreman, 421 U.S. 837, 848 (1975) ("In searching for the meaning and scope of the word 'security' . . . the emphasis should be on economic reality")).

2. Transactions in Regional Transmission Organizations and Independent System Operators.

The Commissions received a comment letter in response to the ANPR requesting clarification regarding the status of transactions in RTOs and ISOs, including financial transmission rights ("FTRs"), under the swap and security-based swap definitions.[153] Section 722 of the Dodd-Frank Act, though, specifically addresses how the CFTC should approach products regulated by FERC that also may be subject to CFTC jurisdiction. Section 722 of the Dodd-Frank Act amended CEA section 4(c)[154] to provide that, if the CFTC determines that an exemption for FERC-regulated instruments or other specified electricity transactions would be in accordance with the public interest, then it shall exempt such instruments or transactions from the requirements of the CEA. Given this specific provision regarding these FERC-related products, the CFTC believes the treatment of these products should be considered under the standards and procedures specified in section 722 of the Dodd-Frank Act for a public interest waiver, rather than through this joint rulemaking to further define the terms "swap" and "security-based swap."

Consequently, the Commissions are not addressing FTRs or other transactions in RTOs or ISOs within this joint definitional rulemaking. Instead, persons with concerns about whether FERC-regulated products may be considered swaps (or futures) should request an exemption pursuant to section 722 of the Dodd Frank Act.[155]

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153 See WGCEF Letter.

154 7 U.S.C. 6(c).

155 This approach, however, should not be taken to suggest any findings by the Commissions as to whether or not FTRs or any other FERC-regulated products are swaps (or futures contracts).

III. The Relationship Between the Swap Definition and the Security-Based Swap Definition.

A. Introduction.

Title VII of the Dodd-Frank Act defines the term "swap" under the CEA,[156] and also defines the term "security-based swap" under the Exchange Act.[157] Pursuant to the regulatory framework established in Title VII, the CFTC has regulatory authority over swaps and the SEC has regulatory authority over security-based swaps. The Commissions are proposing to further define the terms "swap" and "security-based swap" to clarify whether particular agreements, contracts, or transactions are swaps or security-based swaps based on characteristics including the specific terms and conditions of the instrument and the nature of, among other things, the prices, rates, securities, indexes, or commodities upon which the instrument is based.

Because the discussion below is focused on whether particular agreements, contracts, or transactions are swaps or security-based swaps, the Commissions use the term "Title VII instrument" in this release to refer to any agreement, contract, or transaction that is included in either the definition of the term "swap" or the definition of the term "security-based swap." Thus, the term "Title VII instrument" is synonymous with "swap or security-based swap."[158]

The determination of whether a Title VII instrument is a swap or security-based swap should be made based on the facts and circumstances relating to the Title VII instrument at the time that the parties enter into it. If the Title VII instrument itself is not

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156 See CEA section 1a(47), 7 U.S.C. 1a(47).

157 See section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

158 In some cases, the Title VII instrument may be a mixed swap. Mixed swaps are discussed further in part IV below.

amended, modified, or otherwise adjusted during its term by the parties, its characterization as a swap or security-based swap should not change during its duration because of any changes that may occur to the factors affecting its character as a swap or security-based swap.[159]

Classifying a Title VII instrument as a swap or security-based swap is straightforward for most instruments. The Commissions, however, are proposing guidance to clarify the classification of swaps and security-based swaps in certain areas and to provide guidance regarding the use of certain terms and conditions in Title VII instruments.

B. Title VII Instruments Based on Interest Rates, Other Monetary Rates, and Yields.

Parties frequently use Title VII instruments to manage risks related to, or to speculate on, changes in interest rates, other monetary rates or amounts, or the return on various types of assets. Broadly speaking, Title VII instruments based on interest or other monetary rates would be swaps, whereas Title VII instruments based on the yield or value of a single security, loan, or narrow-based security index would be security-based swaps. However, market participants and financial professionals sometimes use the terms "rate" and "yield" in different ways. The Commissions are proposing guidance regarding whether Title VII instruments that are based on interest rates, other monetary rates, or yields would be swaps or security-based swaps and requesting comment as to whether additional clarification in this area would be appropriate.[160]

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159 See discussion infra part III.G.3.a) regarding Title VII instruments based on indexes.

160 Commenters did not address these instruments specifically. A number of commenters urged clarification that various transactions or obligations, such as commercial loans, are

1. Title VII Instruments Based on Interest Rates or Other Monetary Rates That are Swaps.

The Commissions believe that when payments exchanged under a Title VII instrument are based solely on the levels of certain interest rates or other monetary rates that are not themselves based on one or more securities, the instrument would be a swap and not a security-based swap.[161] Often swaps on interest rates or other monetary rates require the parties to make payments based on the comparison of a specified floating rate (such as the London Interbank Offered Rate ("LIBOR")) to a fixed rate of interest agreed upon by the parties. A rate swap also may require payments based on the differences between two floating rates, or it may require that the parties make such payments when any agreed-upon events with respect to interest rates or other monetary rates occur (such as when a specified interest rate crosses a threshold, or when the spread between two such rates reaches a certain point). The rates referenced for the parties' obligations are varied, and examples of such rates include the following:

- Interbank Offered Rates: an average of rates charged by a group of banks for lending money to each other or other banks over various periods of time, and other similar interbank rates,[162] including, but not limited to, LIBOR (regardless of

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not Title VII instruments solely because they reference an interest rate. See BlackRock Letter; Cleary Letter; Farm Credit Council Letter; White & Case Letter. The Commissions have proposed guidance to address such customary commercial transactions in part II.B.3 above.

161 See discussion supra part III.F regarding the use of certain terms and conditions.

162 Interbank lending rates are measured by surveys of the loan rates that banks offer other banks, or by other mechanisms. The periods of time for such loans may range from overnight to 12 months or longer.

The interbank offered rates listed here are frequently called either a "reference rate," the rate of "reference banks," or by a designation that is specific to the service that quotes the rate. For some of the interbank offered rates listed here, there is a similar rate that is currency);[163] the Euro Interbank Offered Rate ("Euribor"); the Canadian Dealer Offered Rate ("CDOR"); and the Tokyo Interbank Offered Rate ("TIBOR");[164]

- Money Market Rates: a rate established or determined based on actual lending or money market transactions, including, but not limited to, the Federal Funds Effective Rate; the Euro Overnight Index Average ("EONIA" or "EURONIA") (which is the weighted average of overnight unsecured lending transactions in the Euro-area interbank market); the EONIA Swap Index; the Australian dollar RBA 30 Interbank Overnight Cash Rate; the Canadian Overnight Repo Rate Average ("CORRA"); the Mexican interbank equilibrium interest rate ("TIIE"); the NZD Official Cash Rate; the Sterling Overnight Interbank Average Rate ("SONIA") (which is the weighted average of unsecured overnight cash transactions brokered in London by the Wholesale Markets Brokers' Association); the Swiss Average Rate Overnight ("SARON"); and the Tokyo Overnight Average Rate ("TONAR") (which is based on uncollateralized overnight average call rates for interbank lending);

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stated as an interbank bid rate, which is the average rate at which a group of banks bid to borrow money from other banks. For example, the bid rate similar to LIBOR is called LIBID.

163 Today, LIBOR is used as a rate of reference for the following currencies: Australian Dollar, Canadian Dollar, Danish Krone, Euro, Japanese Yen, New Zealand Dollar, Pound Sterling, Swedish Krona, Swiss Franc, and U.S. Dollar.

164 Other interbank offered rates include the following (with the country or city component of the acronym listed in parentheses): AIDIBOR (Abu Dhabi); BAIBOR (Buenos Aires); BKIBOR (Bangkok); BRAZIBOR (Brazil); BRIBOR/BRIBID (Btatislava); BUBOR (Budapest); CHIBOR (China); CHILIBOR (Chile); CIBOR (Copenhagen); COLIBOR (Columbia); HIBOR (Hong Kong); JIBAR (Johannesburg); JIBOR (Jakarta); KAIBOR (Kazakhstan); KIBOR (Karachi); KLIBOR (Kuala Lumpur); KORIBOR ((South) Korea); MEXIBOR (Mexico); MIBOR (Mumbai); MOSIBOR (Moscow); NIBOR (Norway); PHIBOR (Philippines); PRIBOR (Prague); REIBOR/REIBID (Reykjavik); RIGIBOR/RIGIBID (Riga); SHIBOR (Shanghai); SIBOR (Singapore); SOFIBOR (Sofia); STIBOR (Stockholm); TAIBOR (Taiwan); TELBOR (Tel Aviv); TRLIBOR and TURKIBOR (Turkey); VILIBOR (Vilnius); VNIBOR (Vietnam); and WIBOR (Warsaw).

- Government Target Rates: a rate established or determined based on guidance established by a central bank including, but not limited to, the Federal Reserve discount rate, the Bank of England base rate and policy rate, the Canada Bank rate, and the Bank of Japan policy rate (also known as the Mutan rate);

- General Lending Rates: a general rate used for lending money, including, but not limited to, a prime rate, rate in the commercial paper market, or any similar rate provided that it is not based on any security, loan, or group or index of securities;

- Indexes: a rate derived from an index of any of the foregoing or following rates, averages, or indexes, including but not limited to a constant maturity rate (U.S. Treasury and certain other rates),[165] the interest rate swap rates published by the Federal Reserve in its "H.15 Selected Interest Rates" publication, the ISDAFIX rates, the ICAP Fixings, a constant maturity swap, or a rate generated as an average (geometric, arithmetic, or otherwise) of any of the foregoing, such as overnight index swaps ("OIS") – provided that such rates are not based on a specific security, loan, or narrow-based group or index of securities;

- Other Monetary Rates: a monetary rate including, but not limited to, the Consumer Price Index ("CPI"), the rate of change in the money supply, or an economic rate such as a payroll index; and

- Other: the volatility, variance, rate of change of (or the spread, correlation or difference between), or index based on any of the foregoing rates or averages of such

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165 A Title VII instrument based solely on the level of a constant maturity U.S. Treasury rate would be a swap because U.S. Treasuries are exempted securities that are excluded from the security-based swap definition. Conversely, a Title VII instrument based solely on the level of a constant maturity rate on a narrow-based index of non-exempted securities under the security-based swap definition would be a security-based swap.

rates, such as forward spread agreements, references used to calculate the variable payments in index amortizing swaps (whereby the notional principal amount of the agreement is amortized according to the movement of an underlying rate), or correlation swaps and basis swaps, including but not limited to, the "TED spread"[166] and the spread or correlation between LIBOR and an OIS.

As discussed above, the Commissions believe that when payments under a Title VII instrument are based solely on any of the foregoing, such Title VII instrument would be a swap.

Request for Comment:

66. The Commissions request comment generally on the foregoing proposed guidance regarding Title VII instruments where the underlying reference is an interest rate or other monetary rate.

67. Does the proposed guidance in this section accurately describe the types of interest rates and other monetary rates that are used as an underlying reference of a Title VII instrument, and that should cause the instrument to be considered a swap? Are any of the rates identified in this list not used in this manner? Are there any significant interest or monetary rates that should be added to this list in order to provide additional guidance?

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[166] The TED spread is the difference between the interest rates on interbank loans and short-term U.S. government debt (Treasury bills or "T-bills"). The latter are exempted securities that are excluded from the statutory definition of the term "security-based swap." Thus, neither any aspect of U.S. Treasuries nor interest rates on interbank loans, can form the basis of a security-based swap. For this reason, a Title VII instrument on a spread between interbank loan rates and T-bill rates also would not be a security-based swap.

68. As discussed above, a Title VII instrument would be considered a security-based swap if the instrument is based on constant maturity rates that are derived from the market prices and yields of a non-exempted debt security or a narrow-based security index of debt securities (depending on the other terms of the Title VII instrument, such instrument may be a mixed swap). The Commissions request comment on this guidance. Are there certain constant maturity rates that should not be considered to be security-based, such that a Title VII instrument based on those rates would instead be a swap and not a security-based swap or mixed swap? If so, are there objective criteria to distinguish between different types of constant maturity rates in the determination of whether a Title VII instrument is a swap or security-based swap? If so, please describe any such criteria in detail.

2. Title VII Instruments Based on Yields.

The Commissions also propose guidance to clarify the status of Title VII instruments in which one of the underlying references of the instrument is a "yield." In cases when a "yield" is calculated based on the price or changes in price of a debt security, loan, or narrow-based security index, it is another way of expressing the price or value of a debt security, loan, or narrow-based security index. For example, debt securities often are quoted and traded on a yield basis rather than on a dollar price, where the yield relates to a specific date, such as the date of maturity of the debt security (i.e., yield to maturity) or the date upon which the debt security may be redeemed or called by the issuer (e.g., yield to first whole issue call).[167]

[167] See, e.g., Securities Confirmations, 47 FR 37920, Aug. 27, 1982.

Except in the case of certain exempted securities, when one of the underlying references of the Title VII instrument is the "yield" of a debt security, loan, or narrow-based security index in the sense where the term "yield" is used as a proxy for the price or value of the debt security loan, or narrow-based security index, the Title VII instrument would be a security-based swap. And, as a result, in cases where the underlying reference is a point on a "yield curve" generated from the different "yields" on debt securities in a narrow-based security index (e.g., a constant maturity yield or rate), the Title VII instrument would be a security-based swap. In either case, however, where certain exempted securities, such as U.S. Treasury securities, are the only underlying reference of a Title VII instrument involving securities, the Title VII instrument would be a swap. Title VII instruments based on exempted securities are discussed further below.

The above interpretation would not apply in cases where the "yield" referenced in a Title VII instrument is not based on a debt security, loan, or narrow-based security index of debt securities but rather is being used to reference an interest rate or monetary rate as outlined above in subsection one of this section. In these cases, this "yield" reference would be considered equivalent to a reference to an interest rate or monetary rate and the Title VII instrument would be, under the guidance in this section, a swap (or mixed swap depending on other references in the instrument).

Request for Comment:

69. The Commissions request comment generally on the foregoing proposed guidance regarding Title VII instruments where the underlying reference is a "yield." Please provide a detailed explanation of any uncertainty regarding the Commissions'

proposed use of the terms "yield" and "yield curve" and what additional guidance would be necessary.

70. Does the proposed guidance in this section appropriately describe instruments based on the "yield" of a debt security that should be considered security-based swaps? Is additional guidance necessary regarding when the term "yield" is used as a proxy for price or value? If so, please provide a detailed explanation of any uncertainty regarding how the term "yield" is used and what additional guidance would be necessary.

71. Are there instruments where the underlying reference is a "yield" of a debt security that should be considered a swap as opposed to a security-based swap? If so, what are they, and how often are they traded? How are such instruments distinguished from instruments based on "yield" that should be considered security-based swaps?

3. Title VII Instruments Based on Government Debt Obligations.

The Commissions also are providing guidance regarding instances in which the underlying reference of the Title VII instrument is a government debt obligation. The security-based swap definition specifically excludes any agreement, contract, or transaction that meets the definition of a security-based swap only because it "references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under [section 3(a)(12) of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in [section 3(a)(29) of the Exchange Act] . . .), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option."[168]

[168] Section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 76c(a)(68)(C).

As a result of this exclusion in the security-based swap definition for "exempted securities,"[169] if the only underlying reference of a Title VII instrument involving securities is, for example, the price of a U.S. Treasury security and does not have any other underlying reference involving securities, then the instrument would be a swap. Similarly, if the Title VII instrument is based on the "yield" of a U.S. Treasury security and does not have any other underlying reference involving securities, then the instrument also would be a swap, regardless of whether the term "yield" is a proxy for the price of the security.

Foreign government securities, by contrast, were not "exempted securities" as of the date of enactment of the Futures Trading Act of 1982[170] and thus do not explicitly fall within this exclusion from the security-based swap definition. Therefore, if the underlying reference of the Title VII instrument is the price, value, or "yield" (where "yield" is a proxy for price or value) of a foreign government security, or a point on a yield curve derived from a narrow-based security index composed of foreign government securities, then the instrument would be a security-based swap.

<u>Request for Comment</u>:

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[169] As of January 11, 1983, the date of enactment of the Futures Trading Act of 1982, Pub. L. 97-444, 96 Stat. 2294, section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), provided that, among other securities, "exempted securities" include: i) "securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States;" ii) certain securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as designated by the Secretary of the Treasury; and iii) certain other securities as designated by the SEC in rules and regulations.

[170] Pub. L. 97-444, 96 Stat. 2294 (1983).

72. The Commissions request comment generally on the foregoing proposed guidance regarding the treatment of Title VII instruments in which the underlying reference is a government debt obligation.

General Request for Comment: In addition to the particular requests for comment set forth on the issues discussed above, the Commissions also request comment generally on the following:

73. Does the proposed guidance in this part III.B accurately describe market practices and terminology? Will the proposed guidance be useful in determining whether Title VII instruments are swaps or security-based swaps?

C. Total Return Swaps.

A TRS is a Title VII instrument in which one counterparty, the seller of the TRS, makes a payment that is based on the price appreciation and income from an underlying security or security index.[171] The other counterparty, the buyer of the TRS, makes a financing payment that is often based on a variable interest rate, such as LIBOR (or other interbank offered rate or money market rate, as described above), as well as a payment based on the price depreciation of the underlying reference. The "total return" consists of the price appreciation or depreciation, plus any interest or income payments.[172]

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171 Where the underlying security is an equity, a TRS is also known as an "equity swap."

172 If the total return is negative, the seller receives this amount from the buyer. TRS can be used to synthetically reproduce the payoffs of a position. For example, two counterparties may enter into a 3-year TRS where the buyer of the TRS receives the positive total return on XYZ security, if any, and the seller of the TRS receives LIBOR plus 30 basis points and the absolute value of the negative total return on XYZ security, if any.

Accordingly, where a TRS is based on a single security or loan, or a narrow-based security index, the TRS would be a security-based swap.[173]

Generally, the use of a variable interest rate in the TRS buyer's payment obligations to the seller is incidental to the purpose of, and the risk that the counterparties assume in, entering into the TRS. These payments are a form of financing that reflects the security-based swap dealer's cost of financing the position or a related hedge, allowing the TRS buyer to receive payments based on the price appreciation and income of a security or security index without purchasing the security or security index. The Commissions believe that when such interest rate payments act merely as a financing component in a TRS, or in any other security-based swap, the inclusion of such interest rate terms would not cause the security-based swap to be characterized as a mixed swap.[174] Financing terms may also involve adding or subtracting a spread to or from the

[173] If the underlying reference of the TRS is a broad-based equity security index, however, the Commissions believe that it would be a swap (and an SBSA) and not a security-based swap. In addition, a TRS on an exempted security, such as a U.S. Treasury, under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of enactment of the Futures Trading Act of 1982) would be a swap (and an SBSA) and not a security-based swap.

[174] Several commenters noted that such instruments should not be characterized as mixed swaps. See Cleary Letter (expressing the view that such Title VII instruments should not be characterized as mixed swaps because "the floating rate payment obligation is not the principal driver of the security-based swap and, in that sense, the security-based swap is not 'based on' the level of an interest rate within the meaning of [the Dodd-Frank Act]"); Deutsche Bank Letter (explaining that such Title VII instruments in which the party that is "synthetically short" the underlying security makes payments based on the value of the underlying security to the party that is "synthetically long," and the synthetically long party pays the synthetically short party an amount that may be based on LIBOR or another interest rate, should not be treated as mixed swaps because the payments to the synthetically short party are generally intended only for financing costs incurred in establishing or maintaining the transaction or its hedge); ISDA Letter (noting that variable interest rate-based payments in connection with a typical Title VII instrument of this type are "incidental to what is essentially a security-based transaction and should not

financing rate,[175] or calculating the financing rate in a currency other than that of the underlying reference security or security index.[176] However, the Commissions note that where such payments incorporate additional elements that create additional interest rate or currency exposures that are unrelated to the financing of the security-based swap, or otherwise shift or limit risks that are related to the financing of the security-based swap, those additional elements may cause the security-based swap to be a mixed swap.

For example, where the counterparties embed interest-rate optionality (e.g., a cap, collar, call, or put) into the terms of a security-based swap in a manner designed to shift or limit interest rate exposure, the inclusion of these terms would cause the TRS to be both be a swap and a security-based swap (i.e., a mixed swap). Similarly, if a TRS is also based on non-security-based components (such as the price of oil, or a currency), the security-based swap would also be a swap.[177]

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yield mixed swap status"); Morgan Stanley Letter (noting that the interest rate-based payments in such Title VII instruments "reflect compensation for the financing costs associated" with the instrument and "are not at the core of what is being 'swapped' under the contract"); Letter from Timothy W. Cameron, Esq., Managing Director, Asset Management Group, Securities Industry and Financial Markets Association, Sept. 20, 2010 (expressing the view that such a financing component is incidental to the Title VII instrument and should not cause it to be viewed as a mixed swap).

175 See, e.g., Moorad Chowdry, "Total Return Swaps: Credit Derivatives and Synthetic Funding Instruments," at 3-4 (noting that the spread to the TRS financing rate is a function of: the credit rating of the counterparty paying the financing rate; the amount, value, and credit quality of the reference asset; the dealer's funding costs; a profit margin; and the capital charge associated with the TRS), available at http://www.yieldcurve.com/Mktresearch/LearningCurve/TRS.pdf.

176 For example, a security-based swap on an equity security priced in U.S. dollars in which payments are made in Euros based on the U.S. dollar/Euro spot rate at the time the payment is made would not be a mixed swap. Under these circumstances, the currency is merely referenced in connection with the method of payment, and the counterparties are not hedging the risk of changes in currency exchange rates during the term of the security-based swap.

177 See Mixed Swaps, infra part IV.

Request for Comment:

74. Is the proposed guidance regarding TRS and other security-based swaps for which the use of a variable interest rate in a counterparty's payment obligations is incidental to the risk that counterparties assume in entering into a TRS or other security-based swap appropriate? Why or why not? If not, please provide a detailed explanation of what guidance would be appropriate.

75. How often do market participants use rates, other than interbank offered rates or money market rates, in TRS to recoup their financing costs? If so, which rates and what portion of the market (broken down by product, country, counterparty type, and/or whatever data are available to commenters), in percentage and/or dollar terms do TRS with such financing rates constitute? What factors influence the financing rates that market participants incorporate into their security-based swaps?

76. Do market participants embed optionality, such a cap, collar, put, or call, into the payment component of a TRS? If so, how frequently and for what purpose?

77. Do market participants embed nonfinancial commodity components into the payment component that directly affect the payments on a TRS rather than operating as a mere financing component? If so, how frequently and for what purpose?

78. Do market participants embed foreign currency swaps into a foreign currency payment component of a TRS? If so, how frequently and for what purpose?

79. Are there other circumstances under which a TRS should be treated as a mixed swap rather than a security-based swap or swap? If so, please provide a detailed description of such circumstances and explain why.

D. Security-Based Swaps Based on a Single Security or Loan and Single-Name Credit Default Swaps.

The second prong of the security-based swap definition includes a swap that is based on "a single security or loan, including any interest therein or on the value thereof."[178] The Commissions believe that, under this prong of the definition of security-based swap, a single-name CDS that is based on a single reference obligation would be a security-based swap because it would be based on a single security or loan (or any interest therein or on the value thereof).

In addition, the third prong of the security-based swap definition includes a swap that is based on the occurrence of an event relating to a "single issuer of a security," provided that such event "directly affects the financial statements, financial condition, or financial obligations of the issuer."[179] This provision applies generally to event-triggered swap contracts. With respect to a CDS, such events could include the bankruptcy of an issuer, a default on one of an issuer's debt securities, or the default on a non-security loan of an issuer.[180] Therefore, the Commissions believe that if the payout on a CDS on a single issuer of a security is triggered by the occurrence of an event relating to that issuer, the CDS would be a security-based swap under the third prong.[181]

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178 Section 3(a)(68)(A)(ii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(II). The first prong of the security-based swap definition is discussed below.

179 Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

180 The Commissions understand that in the context of credit derivatives on asset-backed securities or MBS, the events include principal writedowns, failure to pay principal and interest shortfalls.

181 The Commissions understand that some single-name CDS now trade with fixed coupon payments expressed as a percentage of the notional amount of the transaction and payable on a periodic basis during the term of the transaction. See Markit, "The CDS Big Bang: Understanding the Changes to the Global CDS Contract and North American Conventions," 3, available at

In this regard, the Commissions note that each transaction under an ISDA Master Agreement would need to be analyzed to determine whether it is a swap or security-based swap. For example, the Commissions believe that a number of single-name CDS that are executed at the same time and that are documented under one ISDA Master Agreement, but in which a separate confirmation is sent for each CDS, should be treated as an aggregation of security-based swaps. As a practical and economic matter, the Commissions believe that each such CDS would be a separate and independent transaction. Thus, such an aggregation of single-name CDS would not constitute a "group or index" under the security-based swap definition but instead would constitute multiple single-name CDS.

E. Title VII Instruments Based on Futures Contracts.

A Title VII instrument that is based on a futures contract will either be a swap or a security-based swap, or both (i.e., a mixed swap), depending on the nature of the futures contract, including the underlying reference of the futures contract. The Commissions believe that a Title VII instrument where the underlying reference is a security future would be a security-based swap.[182] The Commissions believe that, except with respect to

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http://www.markit.com/cds/announcements/resource/cds_big_bang.pdf. The Commissions believe the existence of such single-name CDS does not change their interpretation.

182 A security future is specifically defined in both the CEA and the Exchange Act as a futures contract on a single security or a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of enactment of the Futures Trading Act of 1982).

The term security future does not include any agreement, contract, or transaction excluded from the CEA under CEA sections 2(c), 2(d), 2(f), or 2(g), 7 U.S.C. 2(c), 2(d), 2(f), or 2(g), (as in effect on the date of enactment of the Commodity Futures certain futures on foreign government debt securities discussed below, a Title VII instrument where the underlying reference is a futures contract that is not a security future would be a swap.[183]

Title VII instruments involving futures contracts on foreign government debt securities present a unique circumstance. Rule 3a12-8 under the Exchange Act exempts certain foreign government debt securities, for purposes only of the offer, sale, or confirmation of sale of futures contracts on such foreign government debt securities, from all provisions of the Exchange Act which by their terms do not apply to an "exempted security," subject to certain conditions.[184] To date, the SEC has enumerated within rule 3a12-8 debt securities of 21 identified foreign governments solely for purposes of futures trading.[185]

Modernization Act of 2000 ("CFMA") or Title IV of the CFMA). See CEA section 1a(44), 7 U.S.C. 1a(44); section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55).

183 Depending on the underlying reference of the futures contract, though, such swaps could be security-based swap agreements. For example, a swap on a future on the S&P 500 index would be a security-based swap agreement.

184 Specifically, rule 3a12-8 under the Exchange Act requires as a condition to the exemption that the foreign government debt securities not be registered under the Securities Act (or the subject of any American depositary receipt registered under the Securities Act) and that futures contracts on such foreign government debt securities "require delivery outside the United States, [and] any of its possessions or territories, and are traded on or through a board of trade, as defined in [CEA section 2, 7 U.S.C. 2]." See rules 3a12-8(b), 3a12-8(a)(2) under the Exchange Act, 17 CFR 240.3a12-8(b) and 240.3a12-8(a)(2).These conditions were "designed to minimize the impact of the exemption on securities distribution and trading in the United States . . . ." See Exemption for Certain Foreign Government Securities for Purposes of Futures Trading, 49 FR 8595, 8596-97, Mar. 8, 1984 (citing Futures Trading Act of 1982).

185 See rule 3a12-8(a)(1) under the Exchange Act (designating the debt securities of the governments of the United Kingdom, Canada, Japan, Australia, France, New Zealand, Austria, Denmark, Finland, the Netherlands, Switzerland, Germany, Ireland, Italy, Spain, Mexico, Brazil, Argentina, Venezuela, Belgium, and Sweden).

The Commissions are evaluating the appropriate characterization of Title VII instruments based on futures on such foreign government debt securities that are traded in reliance on rule 3a12-8. The Commissions recognize that as a result of the rule 3a12-8 exemption, futures on foreign government debt securities of 21 foreign countries trade pursuant to the CFTC's exclusive jurisdiction and without the futures being considered security futures. Because futures contracts on the 21 foreign government debt securities designated in rule 3a12-8 are not security futures, applying the above interpretive guidance to a Title VII instrument on a futures contract on these foreign government debt securities would mean that such Title VII instrument would be a swap.[186] The Commissions note, however, that the conditions in the rule 3a12-8 exemption were established specifically for trading futures contracts on these foreign sovereign debt obligations, not Title VII instruments based on futures contracts on foreign government debt securities. Furthermore, the Commissions note that the Dodd-Frank Act did not exclude debt securities of foreign governments from the definition of security-based swap. Therefore, a Title VII instrument based on such debt securities would be a security-based swap. Relying on rule 3a12-8 for the treatment of Title VII instruments on such futures would therefore result in different treatments depending on whether the Title VII instrument is based on a foreign government debt security or on a future that is

186 The Commissions note, by contrast, that a Title VII instrument that is based on the price or value of, or settlement into, a futures contract on one of the 21 foreign government debt securities designated in rule 3a12-8 and that is also based on the price or value of, or had the potential to settle directly into, the foreign debt security, would be a security-based swap and, depending on other features of the Title VII instrument, possibly a mixed swap.

in turn based on a foreign government debt security.[187] On the other hand, to do otherwise would create different regulators for a future and Title VII instruments based on that future.

The SEC believes that the characterization of a Title VII instrument involving a foreign government debt security may affect federal securities law provisions relating to the distribution of the underlying foreign debt security. Specifically, the Dodd-Frank Act included provisions that would not permit issuers, affiliates of issuers, or underwriters to use security-based swaps to offer or sell the issuers' securities underlying a security-based swap without complying with the requirements of the Securities Act.[188] In addition, the Dodd-Frank Act provided that any offer and sale of security-based swaps to non-ECPs would have to be registered under the Securities Act.[189] Thus, for example, if a Title VII instrument on a future on foreign government debt security is characterized as a swap, and not a security-based swap, then the provisions of the Dodd-Frank Act enacted to ensure that there could not be offers and sales of securities made without compliance with the Securities Act, either by issuers, their affiliates, or underwriters or to non-ECPs, would not apply to such swap transactions.

On the other hand, the CFTC believes that characterizing Title VII instruments based on a future on a foreign government debt security designated in rule 3a12-8 as security-based swaps could undermine the regulatory scheme that Congress established in

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187 This is the case today (i.e., different treatments) with respect to, for example, options on broad-based security indexes and options on futures on broad-based security indexes.

188 See section 2(a)(3) of the Securities Act as amended by the Dodd-Frank Act, 15 U.S.C. 77b(a)(3). This provision applies regardless of whether the Title VII instrument allows the parties to physically settle any such security-based swap.

189 See section 5 of the Securities Act as amended by the Dodd-Frank Act. 15 U.S.C. 77e.

the CEA. As noted above, the Commissions generally would treat Title VII instruments based on futures that are not security futures as swaps. Many of the futures on the 21 foreign government debt securities designated in rule 3a12-8 trade with substantial volume. Section 753 of the Dodd-Frank Act provided the CFTC with additional antifraud and anti-manipulation authorities patterned on those provided to the SEC in the federal securities laws. The CFTC believes that treating Title VII instruments based on these futures as security-based swaps, while the underlying futures come under the CEA, may undermine those authorities.

In sum, depending on how a Title VII instrument on such a future on a foreign government debt security is characterized, there is potential for such an instrument: i) to be used to avoid the application of the federal securities laws, including the Dodd-Frank Act provisions, that otherwise would apply if the Title VII instrument was instead based on the foreign government debt security directly; or ii) to be used to avoid the application of the CEA, including the Dodd-Frank Act provisions, that otherwise would apply if the Title VII instrument was instead based on any other futures contract that is not a security future. Accordingly, the Commissions also are evaluating whether a Title VII instrument on such a futures contract on a foreign government debt security should be characterized as a mixed swap.

<u>Request for Comment</u>:

80. The Commissions request comment generally on the foregoing discussion regarding Title VII instruments based on futures contracts and security futures.

81. What types of such products are traded in the market today? How often, and where are such products traded?

82. The Commissions are requesting comment on how to characterize a Title VII instrument where the underlying reference is a futures contract on one of the 21 foreign government debt securities that have been designated as "exempted securities" under rule 3a12-8 only for the offer, sale, or confirmation of sale of futures contracts on such securities and only where the conditions of such exemption are satisfied. When should a Title VII instrument on a futures contract on a foreign government debt security being traded in reliance on the exemption under rule 3a12-8 be treated as a swap, a security-based swap or a mixed swap? Is there any economic reason why the treatment of a Title VII instrument on a future on a foreign government debt security should be different than the treatment of a Title VII instrument on the foreign government debt security directly? Is there any economic reason why the treatment of a Title VII instrument on a future on a designated foreign government debt security should be different than the treatment of a Title VII instrument on any other futures contract that is not a security future? If the answer to either of the two preceding questions is yes, please explain and provide empirical analysis. If the Title VII instrument is able to be entered into by the issuer, affiliate of the issuer, or an underwriter, or if the Title VII instrument is being offered and sold to non-ECPs, should the Title VII instrument be viewed as a security-based swap or a mixed swap so that market participants cannot chose whether to comply with the registration requirements of the Securities Act with respect to the foreign government debt securities? Should such an instrument be viewed as a swap or a mixed swap so that market participants cannot choose whether to comply with the requirements of the Dodd-Frank Act concerning clearing, trade execution, reporting, and standards applicable to dealers and major participants that apply to Title VII instruments on futures

contracts that are not security futures? Are there other suggested approaches to the treatment of Title VII instruments on futures on foreign government debt securities that would preserve the application of the Securities Act as contemplated by the Dodd-Frank Act to Title VII instruments involving foreign government debt securities? Are there other suggested approaches to the treatment of Title VII instruments on futures on foreign government debt securities that would preserve the application of the CEA as contemplated by the Dodd-Frank Act to Title VII instruments involving futures contracts that are not security futures? If the answer to either of the two preceding questions is yes, please provide detail and analysis.

F. Use of Certain Terms and Conditions in Title VII Instruments.

The Commissions are aware that market participants' setting of certain fixed terms or conditions of Title VII instruments may be informed by the value or level of a security, rate, or other commodity at the time of the execution of the instrument. The Commissions believe that, in evaluating whether such a Title VII instrument is a swap or security-based swap, the nature of the security, rate, or other commodity that informed the setting of such fixed term or condition should not itself impact the determination of whether the Title VII instrument is a swap or a security-based swap, provided that the fixed term or condition is set at the time of execution of the Title VII instrument and the value or level of that fixed term or condition may not vary over the life of the Title VII instrument.

For example, a Title VII instrument, such as an interest rate swap, in which floating payments based on 3-month LIBOR are exchanged for fixed rate payments of 5% would be a swap, and not a security-based swap, even if the 5% fixed rate was informed by, or quoted based on, the yield of a security, provided that the 5% fixed rate was set at the time of execution and may not vary over the life of the Title VII instrument.[190] Another example would be where a private sector or government borrower that issues a 5-year, amortizing $100 million debt security with a semi-annual coupon of LIBOR plus 250 basis points also, at the same time, chooses to enter into a 5-year interest rate swap on $100 million notional in which this same borrower, using the same amortization schedule as the debt security, receives semi-annual payments of LIBOR plus 250 basis points in exchange for 5% fixed rate payments. The fact that the specific terms of the interest rate swap (e.g., 5-year, LIBOR plus 250 basis point, $100 million notional, fixed amortization schedule) were set at the time of execution to match related terms of a debt security does not cause the interest rate swap to become a security-based swap. However, if the interest rate swap contained additional terms that were in fact contingent on a characteristic of the debt security that may change in the future, such as an adjustment to future interest rate swap payments based on the future price or yield of the debt security, then this Title VII instrument would be a security-based swap that would be a mixed swap.

Request for Comment:

83. Is the guidance provided by the Commissions regarding the relevance of the nature of a security, rate, or other commodity that informs the determination of a fixed term or condition of a Title VII instrument appropriate? Why or why not? If not, what guidance would be appropriate?

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190 However, to the extent the fixed term or condition is set at a future date or at a future value or level of a security, rate, or other commodity rather than the value or level of such security, rate, or other commodity at the time of execution of the Title VII instrument, the discussion above would not apply, and the nature of the security, rate, or other commodity used in determining the terms or conditions would be considered in evaluating whether the Title VII instrument is a swap or security-based swap.

84. The Commissions are aware that quoting conventions are used in the context of setting the fixed terms of certain Title VII instruments, such as interest rate swaps that exchange LIBOR for a fixed rate that is set at the time of execution by reference to U.S. Treasury securities.[191] Are there other Title VII instruments that use such quoting conventions? If so, please provide a detailed explanation of such Title VII instruments and the references they use.

G. The Term "Narrow-Based Security Index" in the Security-Based Swap Definition.

1. Introduction.[192]

As noted above, a Title VII instrument in which the underlying reference of the instrument is a "narrow-based security index" is considered a security-based swap subject to regulation by the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (i.e., the index is broad-based), the instrument is considered a swap subject to regulation by the CFTC. In this section, the Commissions propose rules and guidance regarding several issues regarding the term "narrow-based security index" in the security-based swap definition, including: i) the existing criteria for determining whether a security index is a narrow-based security index and the applicability of past guidance of the Commissions regarding those criteria to Title VII instruments; ii) new criteria for

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191 The Commissions note that such Title VII instruments would be swaps in any event because U.S. Treasury securities are exempted securities that are excluded from the security-based swap definition in Title VII but understand that such swaps use the reference or quoting convention described above in setting the terms or conditions of the Title VII instrument at the time of execution.

192 Four commenters referred to the definition of the term "narrow-based security index," each in the context of CDS. See infra notes 209 and 211.

determining whether a CDS where the underlying reference is a group or index of entities or obligations of entities (typically referred to as an "index CDS") is based on an index that is a narrow-based security index; iii) the meaning of the term "index"; iv) a rule governing the tolerance period for Title VII instruments on security indexes traded on DCMs, SEFs, foreign boards of trade ("FBOTs"), security-based SEFs, or NSEs, where the security index temporarily moves from broad-based to narrow-based or from narrow-based to broad-based; and v) a rule governing the grace period for Title VII instruments on security indexes traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs, where the security index moves from broad-based to narrow-based or from narrow-based to broad-based and the move is not temporary.

2. Applicability of the Statutory Narrow-Based Security Index Definition and Past Guidance of the Commissions to Title VII Instruments.

As defined in the CEA and Exchange Act,[193] an index is a "narrow-based security index" if, among other things, it meets any one of the following four criteria:

- it has nine or fewer component securities;
- a component security comprises more than 30% of the index's weighting;
- the five highest weighted component securities in the aggregate comprise more than 60% of the index's weighting; or

[193] Sections 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C), include a definition of "narrow-based security index" in the same paragraph as the definition of security future. See also CEA sections 1a(35)(A) and (B), 7 U.S.C. 1a(35)(A) and (B). A security future is a contract for future delivery on a single security or narrow-based security index (including any interest therein or based on the value thereof). See section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55), and CEA section 1a(44), 7 U.S.C. 1a(44).

- the lowest weighted component securities comprising, in aggregate, 25% of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with more than 15 component securities, $30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.[194]

The first three criteria apply to the number and concentration of the "component securities" in the index; the fourth criterion applies to the average daily trading volume of an index's "component securities."[195]

This statutory narrow-based security index definition focuses on indexes composed of equity securities and certain aspects of the definition, in particular the evaluation of average daily trading volume, are designed to take into account the trading patterns of individual stocks.[196] However, the Commissions, pursuant to authority granted in the CEA and the Exchange Act, previously have extended the definition to other categories of indexes but modified the definition to take into account the

194 See section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B). See also CEA sections 1a(35)(A) and (B), 7 U.S.C. 1a(35)(A) and (B).

195 The narrow-based security index definition in the CEA and Exchange Act also excludes from its scope security indexes that satisfy certain specified criteria. See sections 3(a)(55)(C)(i) – (vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(i) – (vi), and CEA sections 1a(35)(B)(i) – (vi), 7 U.S.C. 1a(35)(B)(i) – (vi).

196 See Joint Order Excluding Indexes Comprised of Certain Index Options From the Definition of Narrow-Based Security Index, 69 FR 16900, Mar. 31, 2004 ("March 2004 Joint Order").

characteristics of those other categories.[197] Specifically, the Commissions have provided guidance regarding the application of the narrow-based security index definition to futures contracts on volatility indexes[198] and debt security indexes.[199] Today, then, there exists additional guidance for determining what constitutes a narrow-based security index.

Volatility indexes are indexes composed of index options. The Commissions issued a joint order in 2004 to define when a volatility index is not a narrow-based security index. Under this joint order, a volatility index is not a narrow-based security index if the index meets all of the following criteria:

- the index measures the magnitude of changes (as calculated in accordance with the order) in the level of an underlying index that is not a narrow-based security index pursuant to the statutory criteria for equity indexes discussed above;
- the index has more than nine component securities, all of which are options on the underlying index;
- no component security of the index comprises more than 30 percent of the index's weighting;
- the five highest weighted component securities of the index in the aggregate do not comprise more than 60 percent of the index's weighting;

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197 See CEA section 1a(35)(B)(vi), 7 U.S.C. 1a(35)(B)(vi), and section 3(a)(55)(C)(vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(vi).

198 See March 2004 Joint Order, supra note 196.

199 See Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, 71 FR 39434, July 13, 2006 ("July 2006 Rules").

- the average daily trading volume of the lowest weighted component securities in the underlying index (those comprising, in the aggregate, 25 percent of the underlying index's weighting) have a dollar value of more than $50,000,000 (or $30,000,000 in the case of an underlying index with 15 or more component securities), except if there are 2 or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the underlying index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security;

- options on the underlying index are listed and traded on an NSE registered under section 6(a) of the Exchange Act;[200] and

- the aggregate average daily trading volume in options on the underlying index is at least 10,000 contracts calculated as of the preceding 6 full calendar months.[201]

With regard to debt security indexes, the Commissions issued joint rules in 2006 ("July 2006 Rules") to define when an index of debt securities[202] is not a narrow-based

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200 15 U.S.C. 78f(a).

201 See March 2004 Joint Order, supra note 196. In 2009, the Commissions issued a joint order that provided that, instead of the index options having to be listed on an NSE, the index options must be listed on an exchange and pricing information for the index options, and the underlying index, must be computed and disseminated in real time through major market data vendors. See Joint Order To Exclude Indexes Composed of Certain Index Options From the Definition of Narrow-Based Security Index, 74 FR 61116, Nov. 23, 2009 (expanding the criteria necessary for exclusion under the March 2004 Joint Order to apply to volatility indexes for which pricing information for the underlying broad-based security index, and the options that compose such index, is current, accurate, and publicly available).

202 Under the rules, debt securities include notes, bonds, debentures or evidence of indebtedness. See CFTC rule 41.15(a)(1)(i), 17 CFR 41.15(a)(1)(i) and rule 3a55-4(a)(1)(i) under the Exchange Act, 17 CFR 240.3a55-4(a)(1)(i).

security index. The first three criteria of that definition were similar to the statutory definition for equities and the order regarding volatility indexes in that a debt security index would not be narrow based if: i) it had more than 9 debt securities issued by more than 9 non-affiliated issuers; ii) the securities of any issuer included in the index did not comprise more than 30 percent of the index's weighting; and iii) the securities of any five non-affiliated issuers in the index did not comprise more than 60 percent of the index's weighting.

In the July 2006 Rules, instead of the statutory average daily trading volume test, however, the Commissions adopted a public information availability requirement. Under this requirement, assuming the aforementioned number and concentration limits were satisfied, a debt security index would not be a narrow-based security index if the debt securities or the issuers of debt securities in the index met any one of the following criteria:

- the issuer of the debt security is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934;[203]
- the issuer of the debt security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;
- the issuer of the debt security has outstanding securities that are notes, bonds, debentures, or evidence of indebtedness having a total remaining principal amount of at least $1 billion;
- the security is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934[204] and the rules promulgated thereunder; or

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203 15 U.S.C. 78m or 78o(d).

- the issuer of the security is a government of a foreign country or a political subdivision of a foreign country.[205]

The statutory definition of the term "narrow-based security index" for equities, and the Commissions' subsequent guidance as to what constitutes a narrow-based security index with respect to volatility and debt indexes, is applicable in the context of distinguishing between futures contracts and security futures products. In the Dodd-Frank Act, Congress included the term "narrow-based security index" in the security-based swap definition, and thus the statutory definition of the term "narrow-based security index" also applies in distinguishing swaps (on security indexes that are not narrow-based, also known as "broad-based") and security-based swaps (on narrow-based security indexes). Further, the Commissions believe that their prior guidance with respect to what constitutes a narrow-based security index in the context of volatility and debt security indexes should apply in determining whether a Title VII instrument is a swap or a security-based swap.

To clarify that the Commissions are applying the prior guidance and rules to Title VII instruments, the Commissions are proposing rules to further define the term "narrow-based security index" in the security-based swap definition. Under paragraph (1) of proposed rule 1.3(yyy) under the CEA and paragraph (a) of proposed rule 3a68-3 under the Exchange Act, for purposes of the security-based swap definition, the term "narrow-based security index" would have the same meaning as the statutory definition set forth in

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204 15 U.S.C. 78c(a)(12).

205 The July 2006 Rules also provided that debt securities in the index must satisfy certain minimum outstanding principal balance criteria, established certain exceptions to these criteria and the public information availability requirement, and provided for the treatment of indexes that include exempted securities (other than municipal securities).

section 1a(35) of the CEA and section 3(a)(55) of the Exchange Act,[206] and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except as the new rules the Commissions are proposing provide for other treatment, market participants generally will be able to use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

However, the Commissions are proposing interpretive guidance and additional rules regarding Title VII instruments based on a security index. The additional rules and interpretive guidance set forth new narrow-based security index criteria with respect to indexes composed of securities, loans, or issuers of securities referenced by an index CDS. The proposed interpretive guidance and rules also address the definition of an "index" and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated trading platforms and security-based swaps on security indexes that are traded on SEC-regulated trading platforms. These rules and interpretive guidance are discussed in turn below.

3. Narrow-Based Security Index Criteria for Index Credit Default Swaps.

a) In General.

A CDS is a Title VII instrument in which the "protection buyer" makes a series of payments to the "protection seller" and, in return, the "protection seller" is obligated to

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206 7 U.S.C. 1a(35) and 15 U.S.C. 78c(a)(55).

make a payment to the "protection buyer" if an obligation or obligations (typically bonds, but in some cases loans) of an entity or entities referenced in the contract, or the entity or entities themselves, experience a "credit event."[207] While the Commissions understand that the underlying reference for most cleared CDS is a single entity or an index of entities rather than a single security or an index of securities, the underlying reference for CDS also could be a single security or an index of securities.[208] A CDS where the underlying reference is a single entity (i.e., a single-name CDS), a single obligation of a single entity (e.g., a CDS on a specific bond, loan, or asset-backed security, or any tranche or series of any bond, loan, or asset-backed security), or an index CDS where the underlying reference is a narrow-based security index or the issuers of securities in a narrow-based security index would be a security-based swap.[209] An index CDS where

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207 See supra note 180 and accompanying text.

208 See, e.g., Markit, "Markit CDX" (describing the Markit CDX indexes and the number of "names" included in each index), available at http://www.markit.com/en/products/data/indices/credit-and-loan-indices/cdx/cdx.page?; Markit, "Markit iTraxx Indices," (stating that the "Markit iTraxx indices are comprised of the most liquid names in the European and Asian markets") (emphasis added), available at http://www.markit.com/en/products/data/indices/credit-and-loan-indices/itraxx/itraxx.page?]. Examples of indexes based on securities include the Markit ABX.HE and CMBX indexes. See Markit, "Markit ABX.HE," (describing the Markit ABX.HE index as "a synthetic tradeable index referencing a basket of 20 subprime mortgage-backed securities"), available at http://www.markit.com/en/products/data/indices/structured-finance-indices/abx/abx.page; Markit, "Markit CMBX," (describing the Markit CMBX index as "a synthetic tradeable index referencing a basket of 25 commercial mortgage-backed securities"), available at http://www.markit.com/en/products/data/indices/structured-finance-indices/cmbx/cmbx.page.

209 Two commenters made suggestions relating to the effect of the jurisdictional consequences of the definition of the term "narrow-based security index," but neither commented on the meaning of the term itself. One of the two commenters, recognizing that a jurisdictional line would exist for CDS, stressed the need for "substantially identical" regulations applicable to CDS. See Deutsche Bank Letter. The other commenter also noted that a line for CDS would exist and urged the Commissions to adopt a regulation stating that a derivatives clearing organization ("DCO") may be a clearing agency and a clearing agency may be a DCO, in order to facilitate portfolio

the underlying reference is not a narrow-based security index or the issuers of securities in a narrow-based security index (i.e., a broad-based index) would be a swap.[210]

The statutory definition of the term "narrow-based security index," as explained above, was designed with the U.S. equity markets in mind. Thus, the statutory definition is not appropriate for determining whether an index underlying an index CDS is broad or narrow-based. Nor is the further guidance that the Commissions have previously issued with respect to the narrow-based security index definition discussed above necessarily appropriate, because that guidance was designed to address and was uniquely tailored to the characteristics of volatility indexes and debt security indexes in the context of futures. Accordingly, the Commissions are proposing rules that would adopt criteria for determining whether an index is a narrow-based security index within the context of index CDS.[211]

The Commissions are further defining the term "security-based swap," and the use of the term "narrow-based security index" within that definition to modify the criteria applied in the context of index CDS in assessing whether the index is a narrow-based

margining and cross-margining. See White & Case Letter. The Commissions are sensitive to the requirement in section 712(a)(7) of the Dodd-Frank Act to treat functionally or economically similar products or entities in a similar manner.

210 Similarly, an option to enter into a single-name CDS or a CDS referencing a narrow-based security index as described above would be a security-based swap, while an option to enter into a CDS on a broad-based security index or the issuers of securities in a broad-based security index would be a swap. Index CDS where the underlying reference is a broad-based security index would be SBSAs. The SEC has enforcement authority with respect to swaps that are SBSAs, as discussed further in part V below.

211 Two commenters urged clarification of the definition of the term "narrow-based security index" in the context of CDS to ensure that it reflects "the letter and the spirit" of the existing definition. See Letter from Thomas W. Jasper, Chief Executive Officer, Primus Guaranty Ltd., and Gene Park, Chief Executive Officer, Quadrant Structured Investment Advisers, LLC, Sept. 20, 2010 ("Primus and Quadrant Letter").

security index. The third prong of the security-based swap definition includes a Title VII instrument based on the occurrence of an event relating to the "issuers of securities in a narrow-based security index," provided that such event directly affects the "financial statements, financial condition, or financial obligations of the issuer."[212] The first prong of the security-based swap definition includes a Title VII instrument that is based on a "narrow-based security-index."[213] Because the third prong of the security-based swap definition relates to issuers of securities, while the first prong of such definition relates to securities, the Commissions are proposing to further define both the term "narrow-based security index" and the term "issuers of securities in a narrow-based security index" in the context of the definition of security-based swap as applied to index CDS. The Commissions believe it is important to further define both terms in order to ensure consistent analysis of index CDS.[214] While the wording of the two proposed definitions differs slightly, the Commissions expect that they would yield the same substantive results in distinguishing narrow-based and broad-based index CDS.

b) Proposed Rules Regarding the Definitions of "Issuers of Securities in a Narrow-Based Security Index" and "Narrow-Based Security Index" for Index Credit Default Swaps.

The Commissions are considering how to further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" in order to provide for appropriate criteria for determining whether an index composed of issuers

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212 Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

213 Section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I).

214 Because it applies only with respect to index CDS, the proposed definitions of "issuers of securities in a narrow-based security index" and "narrow-based security index" would not apply with respect to other types of event contracts, whether analyzed under the first or third prong.

of securities referenced by an index CDS and an index composed of securities referenced by an index CDS are narrow-based security indexes. In formulating these criteria, and consistent with the guidance and rules the Commissions have previously issued and adopted regarding narrow-based security indexes in the context of security futures, the Commissions believe that there should be public information available about a predominant percentage of the reference entities underlying the index, or, in the case of an index CDS, on an index of securities, about the issuers of the securities or the securities underlying the index, in order to reduce the likelihood that non-narrow-based indexes referenced in index CDS or the component securities or issuers of securities in that index would be readily susceptible to manipulation, as well as to help prevent the misuse of material non-public information through the use of CDS based on such indexes.

To satisfy these objectives, the Commissions intend to use the criteria developed for debt indexes discussed above[215] but tailor the criteria specifically to address index CDS.[216] These criteria would be used solely for the purpose of defining the terms

215 See discussion of July 2006 Rules, supra note 199.

216 The Commissions note that the language of the proposed rules is intended, in general, to track the criteria developed for debt indexes discussed above. Certain changes from the criteria developed for debt indexes are necessary to address differences between futures on debt indexes and index CDS. Certain other changes are necessary because the rules for debt indexes define under what conditions an index is not a narrow-based security index, whereas the proposed rules define what is a narrow-based security index. For example, an index is not a narrow-based security index under the rule for debt indexes if it is not a narrow-based security index under either subparagraph (a)(1) or paragraph (a)(2) of the rule. Under the proposed rules for index CDS, however, an index is a narrow-based security index if it meets the requirements of both of the counterpart paragraphs in the proposed rules regarding index CDS (paragraphs (1)(i) and (1)(ii) of proposed rules 1.3(xxx) and 1.3(aaaa) under the CEA and paragraphs (a)(1) and paragraph (a)(2) of proposed rules 3a68-1a and 3a68-1b under the Exchange Act), even

"narrow-based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS and would not be interpreted to affect any other interpretation or use of the term "narrow-based security index" or any other provision of the Dodd-Frank Act, CEA, or Exchange Act.

i) Number and Concentration Percentages of Reference Entities or Securities.

The Commissions believe that the first three criteria of the debt security index test discussed above (i.e., the number and concentration weighting requirements) are appropriate to apply to index CDS, whether CDS on indexes of securities or indexes of issuers of securities.

Accordingly, proposed rules 1.3(zzz) under the CEA and proposed rule 3a68-1a under the Exchange Act would provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Exchange Act,[217] the term "issuers of securities in a narrow-based security index" would include issuers of securities identified in an index in which:

- Number: There are 9 or fewer non-affiliated issuers of securities that are reference entities[218] in the index, provided that an issuer of securities shall not be deemed

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though the criteria in the debt index rules and the proposed rules for index CDS include generally the same criteria and structure.

217 15 U.S.C. 78c(a)(68)(A)(ii)(III).

218 For purposes of proposed rules 1.3(zzz) and 3a68-1a: i) a reference entity would be affiliated with another entity if it controls, is controlled by, or is under common control with, that entity; ii) control would mean ownership of 20 percent or more of an entity's equity, or the ability to direct the voting of 20 percent or more of the entity's voting equity; and iii) the term "reference entity" would include an issuer of securities, an issuing entity of asset-backed securities, and a single reference entity or group of

a reference entity in the index unless i) a credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the related notional amount allocated to such reference entity, or ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the CDS with respect to any future credit events;

- Single Component Concentration: The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting; or

- Largest Five Component Concentration: The effective notional amount allocated to any 5 non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting.[219]

Similarly, proposed rules 1.3(aaaa) under the CEA and proposed rule 3a68-1b under the Exchange Act would provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange

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affiliated entities; provided that an issuing entity of an asset-backed security shall not be affiliated with any other issuing entity or issuer under this proposed definition.

219 These proposed rules refer to the "effective notional amount" allocated to reference entities or securities in order to address potential situations in which the means of calculating payout across the reference entities or securities is not uniform. Thus, if one or more payouts is leveraged or enhanced by the structure of the transaction (i.e., 2x recovery rate), that amount would be the "effective notional amount" for purposes of the 30% and 60% tests in paragraphs (1)(i)(B) and (1)(i)(C) of proposed rules 1.3(zzz) and 1.3(aaaa) and paragraphs (a)(1)(ii) and (a)(1)(iii) of proposed rules 3a68-1a and 3a68-1b. Similarly, if the aggregate notional amount under a CDS is not uniformly allocated to each reference entity or security, then the portion of the notional amount allocated to each reference entity or security (which may be by reference to the product of the aggregate notional amount and an applicable percentage) would be the "effective notional amount."

Act,[220] the term "narrow-based security index" would include an index in which essentially the same criteria apply, substituting securities for issuers. Under these proposed criteria, the term "narrow-based security index" would mean an index in which:

- Number: There are 9 or fewer securities, or securities that are issued by 9 or fewer non-affiliated issuers,[221] in the index, provided that a security shall not be deemed a component of the index unless i) a credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the related notional amount allocated to such security, or ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the CDS with respect to any future credit events;

- Single Component Concentration: The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting; or

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220 15 U.S.C. 78c(a)(68)(A)(ii)(I).

221 This language is intended to be consistent with the language in the rule for debt indexes but the specific language is different to deal with the differences in structure between the rule for debt indexes and proposed rules 1.3(aaaa) and 3a68-1b. See discussion supra note 216.

For purposes of proposed rules 1.3(aaaa) and 3a68-1b: i) an issuer would be affiliated with another issuer if it controls, is controlled by, or is under common control with, that issuer; ii) control would mean ownership of 20 percent or more of an issuer's equity, or the ability to direct the voting of 20 percent or more of the issuer's voting equity; and iii) the term "issuer" would include an issuer of securities, an issuing entity of asset-backed securities, and a single issuer or group of affiliated issuers; provided that an issuing entity of an asset-backed security shall not be deemed affiliated with any other issuing entity or issuer under this proposed definition.

- Largest Five Component Concentration: The effective notional amount allocated to the securities of any 5 non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting.

Thus, the applicability of the proposed rules would depend on conditions relating to the number of non-affiliated reference entities, issuers of securities, or securities, as applicable, included in an index and the weighting of notional amounts allocated to the reference entities or securities in the index, as applicable. These first three criteria of the proposed rules would evaluate the number and concentration of the issuers or securities in the index, as applicable, and ensure that an index with a small number of issuers or securities or concentrated in only a few issuers or securities would be narrow-based, and thus where such index is the underlying reference of an index CDS, the index CDS would be a security-based swap.

Specifically, the proposed rules would provide that an index meeting any one of certain identified conditions would be a narrow-based security index. The first condition in paragraph (1)(i)(A) of proposed rule 1.3(zzz) under the CEA and paragraph (a)(1)(i) of proposed rule 3a68-1a under the Exchange Act is that there are 9 or fewer non-affiliated issuers of securities that are reference entities in the index. An issuer of securities would count toward this total only if a credit event with respect to such entity would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the notional amount allocated to such entity, or if the fact of such a credit event or the calculation of the payment with respect to such credit event is taken into account when determining whether to make any future payments under the CDS with respect to any future credit events.

Similarly, the first condition in paragraph (1)(i)(A) of proposed rules 1.3(aaaa) under the CEA and paragraph (a)(1)(i) of proposed rule 3a68-1b under the Exchange Act would provide that a security would count toward the total number of securities in the index only if a credit event with respect to such security, or the issuer of such security, would result in a payment by the credit protection seller to the credit protection buyer under the CDS based on the notional amount allocated to such security, or if the fact of such a credit event or the calculation of the payment with respect to such credit event is taken into account when determining whether to make any future payments under the CDS with respect to any future credit events. These provisions are intended to ensure that an index concentrated in a few reference entities or securities, or a few reference entities that are affiliated or a few securities issued by a few issuers that are affiliated, are within the "narrow-based" definition and that an entity is not counted as a reference entity in the index, and a security is not counted as a security in the index, unless a credit event with respect to the entity, issuer, or security affects payout under a CDS on the index.[222]

In addition, the proposed rules would provide that a reference entity or issuer of a security in an index and any of that reference entity's or issuer's affiliated entities are deemed to be a single reference entity or issuer in the index.[223] For purposes of the narrow-based security index definition for index CDS under the third prong and first prong, a reference entity or issuer would be affiliated with another entity if it controls, is

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222 This requirement is generally consistent with the definition of "narrow-based security index" in CEA section 1a(35)(A), 7 U.S.C. 1a(35)(A), and section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B), and the July 2006 Rules, supra note 199.

223 See proposed rule 1.3(zzz)(4) under the CEA and proposed rule 3a68-1a(d) under the Exchange Act.

controlled by, or is under common control with, that other entity or issuer. The proposed rules would define control, solely for purposes of this provision, to mean ownership of 20% or more of an entity's or issuer's equity or the ability to direct the voting of 20% or more of an entity's or issuer's voting equity.[224] This definition of control is designed to provide a clear standard for determining affiliation for purposes of the narrow-based security index criteria with respect to index CDS. Determining whether a reference entity or issuer is affiliated with another entity or issuer is important in assessing whether an index meets the criteria in the proposed rules because the notional amounts allocated to all affiliated reference entities, or all securities issued by affiliated issuers, included in an index must be aggregated in order to prevent a concentration of the index in reference entities or securities issued by issuers that are affiliated and because a reference entity's and issuer's affiliates must be considered when determining whether the reference entity or security meets the public information availability test discussed below. In addition, in order to ensure application of the criteria regarding index CDS to indexes of reference entities that have issued asset-backed securities as defined in section 3(a)(77) of the Exchange Act,[225] as well as indexes of such asset-backed securities, the term reference entity and the term issuer under the proposed rules includes issuing entities of asset-

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[224] The affiliate issue under the federal securities laws is generally a facts and circumstances determination based on the definition of the term "affiliate" contained in such laws. See, e.g., rule 405 under the Securities Act, 17 CFR 230.405; rule 12b-2 under the Exchange Act, 17 CFR 240.12b-2.

[225] 15 U.S.C. 78c(a)(77). The Commissions note that section 941 of the Dodd-Frank Act added the definition of the term "asset-backed security" as section 3(a)(77) of the Exchange Act, 15 U.S.C. 78c(a)(77). However, section 761(a)(6) of the Dodd-Frank Act also added the definition of the term "security-based swap execution facility" as section 3(a)(77) of the Exchange Act, 15 U.S.C. 78c(a)(77). References to the definition of the term "asset-backed security" in this release are to the definition added by section 941 of the Dodd-Frank Act.

backed securities. The proposed rules also would provide that each issuing entity of an asset-backed security is considered a separate reference entity or issuer, as applicable.

The second condition, in paragraphs (1)(i)(B) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(ii) of proposed rules 3a68-1a and 3a68-1b under the Exchange Act, is that the effective notional amount allocated to any reference entity or security included in the index comprises more than 30 percent of the index's weighting.

The third condition, in paragraphs (1)(i)(C) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(iii) of proposed rules 3a68-1a and 3a68-1b under the Exchange Act, is that the effective notional amount allocated to any 5 non-affiliated reference entities, or to the securities of any 5 non-affiliated issuers, included in the index that are the underlying reference entities or securities, respectively, comprises more than 60 percent of the index's weighting.

Given that Congress determined that these concentration percentages are appropriate to characterize an index as a narrow-based security index, and the Commissions have determined they are appropriate for debt security indexes in the security futures context, the Commissions believe that these concentration percentages are appropriate to apply to the notional amount allocated to reference entities and securities in order to apply similar standards to indexes that are the underlying references of index CDS. Moreover, with respect to both the numerical and concentration percentage criteria, the markets have had experience with these criteria with respect to futures on equity indexes, volatility indexes, and debt security indexes.

ii) Public Information Availability Regarding Reference Entities and Securities.

In addition to the numerical and concentration percentage criteria, the debt security index test also included, as discussed above, a public information availability test. This test was designed to reduce the likelihood that broad-based debt security indexes or the component securities or issuers of securities in that index would be readily susceptible to manipulation. The fourth condition in the proposed rules includes a similar public information availability test that is intended solely for purposes of determining whether an index underlying a CDS is narrow-based. Except as discussed below, under the proposed rules, an index CDS would be considered narrow-based if a reference entity or security included in the index does not meet any one of the following criteria:

- the reference entity or the issuer of the security is required to file reports pursuant to the Exchange Act or the regulations thereunder;
- the reference entity or the issuer of the security is eligible to rely on the exemption provided in rule 12g3-2(b) under the Exchange Act;[226]
- the reference entity or the issuer of the security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;[227]
- the reference entity or the issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Exchange Act[228])

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226 17 CFR 240.12g3-2(b).

227 See July 2006 Rules, supra note 199, at 39537 (noting that issuers having worldwide equity market capitalization of $700 million are likely to have public information available about them).

228 15 U.S.C. 78c(a)(77).

has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

- the reference entity is an issuer of an exempted security, or the security is an exempted security, each as defined in section 3(a)(12) of the Exchange Act[229] and the rules promulgated thereunder (except a municipal security);

- the reference entity or the issuer of the security is a government of a foreign country or a political subdivision of a foreign country; or

- if the reference entity or the issuer of the security is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Exchange Act,[230] such asset-backed securities were issued in a transaction registered under the Securities Act and have publicly available distribution reports.

However, so long as the effective notional amounts allocated to reference entities or securities that satisfy the public information availability test comprise at least 80 percent of the index's weighting, failure by a reference entity or security included in the index to satisfy the public information availability test would be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than 5 percent of the index's weighting.

These issuer eligibility criteria are intended to condition the characterization of an index as "narrow-based" on the likelihood that information about a predominant percentage of the reference entities or securities included in the index is publicly

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229 15 U.S.C. 78c(a)12.

230 15 U.S.C. 78c(a)(77).

available.[231] For example, a reference entity or issuer of securities that is required to file reports pursuant to the Exchange Act or the regulations thereunder makes regular and public disclosure through those filings. Moreover, reference entities and issuers of securities that do not file reports with the SEC but that are eligible to rely on the exemption in rule 12g3-2(b) under the Exchange Act (i.e., foreign private issuers) are required to make certain types of financial information publicly available in English on their websites or through an electronic information delivery system generally available to the public in their primary trading markets.[232] The Commissions believe that other reference entities or issuers of securities that do not file reports with the SEC, but that have worldwide equity market capitalization of $700 million, have $1 billion in outstanding debt (other than in the case of issuing entities of asset-backed securities), issue exempted securities (other than municipal securities), or are foreign sovereign entities either are required to or are otherwise sufficiently likely, solely for purposes of the proposed "narrow-based security-index" and "issuers of securities in a narrow-based security index" definitions, to have public information available about them.[233]

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231 See discussion supra part III.G.3.b). Most of the thresholds in the public information availability test are similar to those the Commissions adopted in their joint rules regarding the application of the definition of the term "narrow-based security index" to debt security indexes and security futures on debt securities. See July 2006 Rules, supra note 199. The July 2006 Rules also included an additional requirement regarding the minimum principal amount outstanding for each security in the index. The Commissions have not included this requirement in proposed rule 1.3(zzz) under the CEA and proposed rule 3a68-1a under the Exchange Act. The numerical thresholds also are similar to those the SEC adopted in its securities offering reform rules, which were based on data analysis conducted by the SEC's Office of Economic Analysis. See Securities Offering Reform, 70 FR 44722, Aug. 3, 2005.

232 17 CFR 240.12g3-2(b).

233 It is important to note that the public information availability test is designed solely for purposes of distinguishing between index CDS that are swaps and index CDS that are security-based swaps. The proposed criteria are not intended to provide any assurance

In the case of indexes including asset-backed securities, or reference entities that are issuing entities of asset-backed securities, information about the reference entity or issuing entity of the asset-backed security would not alone be sufficient and, consequently, the proposed rules provide that the public information availability test would be satisfied only if certain information also is available about the asset-backed securities. An issuing entity (whether or not a reference entity) of asset-backed securities may meet the public information availability test if such asset-backed securities were issued in a transaction registered under the Securities Act and distribution reports about such asset-backed securities are publicly available. In addition, because of the lack of public information regarding many asset-backed securities, despite the size of the outstanding amount of securities,[234] the proposed rules would not permit such reference entities and issuers to satisfy the public information availability test by having $1 billion in outstanding debt. Characterizing an index with reference entities or securities for which public information is not likely to be available as "narrow-based," and thus index CDS where the underlying references or securities are such indexes as security-based swaps, should help to ensure the transparency of the index components.

In sum, an index that is not narrow-based under the number and weighting requirements would be characterized as broad-based (and thus an index CDS, where the

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that there is any particular level of information actually available regarding a particular reference entity or issuer of securities. Meeting one or more of the proposed criteria for the limited purpose here – defining the terms "narrow-based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS – would not substitute for or satisfy any other requirement for public disclosure of information or public availability of information for purposes of the federal securities laws.

234 See generally Asset-Backed Securities, 75 FR 23328, May 3, 2010.

underlying reference is that index, would be characterized as a swap and not a security-based swap) unless one of the reference entities or securities in the index fails to meet one of the criteria in the public information availability test set forth in the proposed rules. Yet, even if one or more of the reference entities or securities included in the index fail the public information availability test, the proposed rules would provide that the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" would not include such an index, so long as the applicable reference entity or security that failed the test represents less than 5 percent of the index's weighting, and so long as reference entities or securities comprising at least 80 percent of the index's weighting do satisfy the public information availability test.

An index that includes a very small proportion of reference entities or securities that do not satisfy this public information availability test should nevertheless be treated as a broad-based security index. This would be achieved where the index satisfies both of the requirements at the time the parties enter into the index CDS. The 5-percent weighting threshold is designed to provide that reference entities or securities not satisfying the public information availability test comprise only a very small portion of the index, and the 80-percent weighting threshold is designed to provide that a predominant percentage of the reference entities or securities in the index satisfy the public information availability test. As a result, these thresholds would provide market participants with flexibility in constructing an index. The Commissions believe that this provision is appropriate and that providing such flexibility is not likely to increase the likelihood that an index that satisfies these provisions would be readily susceptible to manipulation or the likelihood that the component securities or issuers of securities in that index also would be subject to manipulation or that there would be misuse of material non-public information about them through the use of CDS based on such indexes.

The Commissions also are proposing that, for index CDS entered into solely between ECPs, the public information availability test may instead be satisfied other than in the manner discussed above. Accordingly, solely for index CDS entered into between ECPs, an index would be considered narrow-based if a reference entity or security included in the index does not meet any one of the criteria enumerated above or any one of the following criteria:

- the reference entity or the issuer of the security (other than issuing entities of asset-backed securities) provides to the public or to such eligible contract participant information about such reference entity or issuer pursuant to rule 144A(d)(4) under the Securities Act;[235]

- financial information about the reference entity (other than an issuing entity of asset-backed securities) is otherwise publicly available; or

- in the case of an asset-backed security, or a reference entity that is an issuing entity of asset-backed securities, information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the reference entity or issuing entity as well such asset-backed securities.

Reference entities or reference securities that meet alternative public information criteria currently may underlie CDS that are entered into by ECPs and that are cleared by

[235] 17 CFR 230.144A(d)(4).

central counterparties operating pursuant to exemptive orders granted by the SEC.[236] In addition, solely with respect to index CDS entered into by ECPs, so long as the effective notional amounts allocated to reference entities or securities that satisfy this expanded public information availability test comprise at least 80 percent of the index's weighting, a reference entity or security included in the index that fails to satisfy this expanded public information availability test would be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than 5 percent of the index's weighting.

The Commissions are also seeking comment as to whether the public information availability test should apply to the extent that an index is compiled by an index provider that is not a party to an index CDS ("third-party index provider") and makes publicly available general information about the construction of the index, index rules, identity of components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC.

The CFTC believes that the requirement that the index be compiled by a third-party index provider may help to ensure that information is publicly available because such index providers generally employ a variety of selection criteria for inclusion of

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236 See, e.g., Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Inc. and Citadel Investment Group, L.L.C. Related to Central Clearing of Credit Default Swaps, and Request for Comments, Exchange Act Release No. 34-59578 (Mar. 13, 2009). This order has been extended a number of times, most recently on November 29, 2010. See Order Extending Temporary Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Inc. Related to Central Clearing of Credit Default Swaps and Request for Comment, Exchange Act Release No. 34-63388 (Nov. 29, 2010).

reference entities or securities in the indexes for index CDS, including liquidity thresholds. The CFTC believes that requiring that such index providers make publicly available general information about the construction of the index, index rules, components, and predetermined adjustments may help ensure transparency regarding the index and its components. In addition, the CFTC believes that the requirement that the index be the underlying reference of an index CDS that is offered for trading on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from a registered FBOT, helps to ensure that information about the index is publicly available and that the index is not readily susceptible to manipulation. The CEA prohibits DCMs and SEFs from offering for trading contracts that are readily susceptible to manipulation.[237] Similarly, under rules recently proposed by the CFTC, FBOTs only may offer contracts by direct access from the U.S. that are not readily susceptible to manipulation.[238] The CFTC believes that CFTC oversight of DCMs, SEFs and registered FBOTs for compliance with these requirements[239] will help ensure that information about an index that is the underlying reference of an index CDS traded on these platforms is publicly available and is not readily susceptible to manipulation.[240]

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237 See CEA sections 5(d)(3), 7 U.S.C. 7(d)(3) (a DCM "shall list on the contract market only contracts that are not readily susceptible to manipulation."); 5h(f)(3), 7 U.S.C. 7b-3(f)(3) (same requirement for SEFs).

238 See Registration of Foreign Boards of Trade, 75 FR 70973, Nov. 19, 2010.

239 CFTC oversight in evaluating compliance with the requirement that a swap not be readily susceptible to manipulation for cash settled contracts includes consideration of whether cash settlement is at a price reflecting the underlying cash market, will not be subject to manipulation or distortion, and is based on a cash price series that is reliable, acceptable, publicly available, and timely. See 17 CFR Part 40, Appendix A—Guideline No. 1.

240 Such indexes also would be SBSAs, providing the SEC with antifraud and anti-manipulation authority.

The SEC believes that a third-party index provider that simply provides general information about the construction of an index, index rules, components, and predetermined adjustments is not a substitute for the public availability of information about the issuers of the securities or the securities in the index; nor does such a third-party index provider indicate a likelihood that such public information is available, which the SEC believes, for purposes of index CDS, is important to market integrity and to investors in engaging in transactions based on such indexes. If a third-party index provider does not require, as a condition of inclusion in an index it compiles, that information likely is publicly available regarding the component issuers or securities in the index, the SEC does not believe investors will have adequate information regarding such component issuers or securities. In addition, the SEC notes that, absent specified standards regarding what persons constitute a third-party index provider for purposes of the proposed rules, any person that compiles an index at the behest of another person could constitute a "third-party index provider." Moreover, the SEC does not believe that requiring an index CDS to be offered on or subject to the rules of a DCM or SEF, or by an FBOT, addresses whether public information likely is available about the issuers of securities or securities in an index compiled by a third-party index provider. As a result, the SEC does not believe that an index compiled by a third-party index provider that makes publicly available general information about the construction of the index, index rules, components, and index adjustments, and that is referenced by an index CDS that is offered for trading on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from a registered FBOT, should substitute for the public information availability test under the proposed rules for index CDS.

Accordingly, the Commissions seek comment as to whether the public information availability test should apply to indexes compiled by a third-party index provider that makes publicly available general information about the construction of the index, index rules, identity of components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC.

iii) Treatment of Indexes Including Reference Entities That Are Issuers of Exempted Securities or Including Exempted Securities.

In addition, the proposed rules provide for alternative treatment of indexes that include exempted securities or reference entities that are issuers of exempted securities.[241] The Commissions believe such treatment is consistent with the objective and intent of the definition of the term "security-based swap," as well as the approach taken in the context of security futures.[242] Accordingly, paragraph (1)(ii) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of proposed rules 3a68-1a and 3a68-1b under the Exchange Act would provide that, in the case of an index that includes exempted securities, or reference entities that are issuers of exempted securities, in each case as defined as of the

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241 See proposed rules 1.3(zzz)(1)(i) and 1.3(aaaa)(1)(i) under the CEA and proposed rules 3a68-1a(a)(2) and 3a68-1b(a)(2) under the Exchange Act; July 2006 Rules, supra note 199.

242 See section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that "[t]he term 'security-based swap' does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option").

date of enactment of the Futures Trading Act of 1982 (other than municipal securities), such securities or reference entities are excluded from the index when determining whether the securities or reference entities in the index constitute a "narrow-based security index" or "issuers of securities in a narrow-based security index" under the proposed rules.

Under paragraph (1)(ii) of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of proposed rules 3a68-1a and 3a68-1b) under the Exchange Act, an index composed solely of securities that are, or reference entities that are issuers of, exempted securities (other than municipal securities) would not be a "narrow-based security index" or an index composed of "issuers of securities in a narrow-based security index." In the case of an index where some, but not all, of the securities or reference entities are exempted securities (other than municipal securities) or issuers of exempted securities (other than municipal securities), the index would be a "narrow-based security index" or an index composed of "issuers of securities in a narrow-based security index" only if the index is narrow-based when the securities that are, or reference entities that are issuers of, exempted securities (other than municipal securities) are disregarded. The Commissions believe this approach would result in consistent treatment for indexes regardless of whether they include securities that are, or issuers of securities that are, exempted securities (other than municipal securities) while ensuring that exempted securities (other than municipal securities) and issuers of exempted securities (other than municipal securities) are not included in an index merely to make the index either broad-based or narrow-based under the proposed rules.

Request for Comment:

The Commissions request comment on all aspects of proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and proposed rules 3a68-1a and 3a68-1b under the Exchange Act, as applied to CDS, including the following:

85. Do the proposed criteria for identifying when an index of reference entities constitutes "issuers of securities in a narrow-based security index" and when an index of securities constitutes a "narrow-based security index" effectively encompass the key elements of a narrow-based security index as it pertains to paragraph (A)(ii)(III) (i.e., the third prong) and paragraph (A)(ii)(I) (i.e., the first prong) of the security-based swap definition? Why or why not?

86. Should an index with 9 or fewer non-affiliated issuers of securities or 9 or fewer securities be "narrow-based?" Why or why not?

87. Should an index in which the effective notional amounts allocated to any reference entity or security included in the index comprise more than 30 percent of the index's weighting be "narrow-based"? Why or why not?

88. Should an index in which the effective notional amounts allocated to any 5 non-affiliated reference entities or securities included in the index comprise more than 60 percent of the index's weighting be "narrow-based"? Why or why not?

89. Should an index in which publicly available information is not available for a predominant percentage of reference entities or securities included in the index be "narrow-based" for purposes of index CDS? Why or why not? The Commissions note that the criteria for the public information availability test do not necessarily ensure that there is in fact public information available regarding the relevant entities or securities, or that the criteria act in any way as a substitute for the actual availability of public

information; instead, the criteria, taken as a whole, are intended to capture, for purposes of the definition of the term "narrow-based security index" for index CDS, those entities or securities, that on average, are likely to have public information available, and that the relevant index would therefore not be treated as "narrow-based." Do the proposed criteria appropriately achieve this objective? Are the criteria for the public information availability test under the proposed rules appropriate to result in a sufficient likelihood that public information about the component securities or issuers of securities in an index CDS would be available to properly address the regulatory interests of the federal securities laws? Are the $700 million and $1 billion thresholds discussed above appropriate tests for the likelihood of publicly available information in this context? These thresholds are similar to those in the SEC securities offering reform rules used to determine, in part, whether a particular issuer was a "well-known seasoned issuer," in order to streamline registration requirements under the Securities Act.[243] Are there companies that have less than $700 million in worldwide equity capitalization, or less than $1 billion in outstanding debt (other than asset-backed securities), and that do not otherwise satisfy the public information availability test, that have public information available about them for purposes of determining whether an index CDS that includes such a company as a reference entity or such a security is broad or narrow-based? The Commissions request comment on the appropriate thresholds for determining whether there likely is public information available for purposes of the proposed definition of narrow-based security index and issuers of securities in a narrow-based security index for

243 See supra note 231.

purposes of index CDS, in particular whether these thresholds should be modified higher or lower, and request empirical data to support the response.

90. Is it appropriate to treat an issuer eligible to rely on rule 12g3-2(b) under the Exchange Act as meeting the public information availability test under the proposed rules? Why or why not? Would such a provision include issuers that otherwise would not satisfy the information condition in the proposed rules? Why or why not? Please provide a detailed explanation and include empirical data to support any suggested modification.

91. With respect to asset-backed securities, is the proposed criterion for meeting the public information availability test, that the asset-backed securities were issued in a transaction registered under the Securities Act and have publicly available distribution reports, the correct approach? Why or why not? Should such a provision explicitly also apply to include asset-backed securities issued by Fannie Mae and Freddie Mac? Why or why not? Please provide a detailed explanation of whether and why such a condition is necessary and include empirical data to support any suggested modification.

92. Should the proposed rules exclude a reference entity or security in the index from the public information availability test, so long as the reference entity or security included in the index represents less than five percent of the index's weighting? Why or why not?

93. Should the proposed rules exclude a reference entity or security in the index from the public information availability test, so long as the reference entities or

securities comprising at least 80 percent of the index's weighting satisfy the provisions of those paragraphs? Why or why not?

94. The Commissions are considering whether the public information availability test in proposed rules 1.3(zzz) and 1.3(aaaa) under the CEA and proposed rules 3a68-1a and 3a68-1b under the Exchange Act should apply to an index of issuers of securities or securities that is created and published by a third-party index provider that is not a party to an index CDS and makes publicly available general information about the construction of the index, index rules, components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC. How are indexes created by such a third-party index provider and what type of compensation do they receive? What role do parties to a swap or security-based swap play in determining the constituents or index criteria? What type of information does a third-party index provider ensure is publicly available on an ongoing basis about each of the constituent issuers of securities or securities identified in the index and what actions does the third-party index provider take to ensure the accuracy of information about the issuers of securities or securities in any index compiled by such third-party index provider? How would a third-party index provider take steps to ensure that the indexes it creates are composed of issuers of securities or securities for which there likely is public information available? Please provide detailed examples.

95. If the Commissions determine to use, as an alternative to the public information availability test in the proposed rules relating to index CDS, the existence of a third-party index provider that is not a party to an index CDS and makes publicly

available general information about the construction of the index, index rules, components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC, what requirements, if any, should the Commissions impose on the DCM, SEF, or FBOT to ensure that public information likely will be available in this context regarding the issuers of securities or securities in the index? What specified standards, if any, should the Commissions require the DCM, SEF, or FBOT to meet for purposes of the proposed rules?

96. Should index CDS based on an index compiled by a third-party index provider as described in this section be considered a "mixed swap" rather than a swap in order to ensure that the protections of the federal securities laws apply with respect to index constituents about which public information about the constituent issuers of securities or securities in the index (subject to the de minimis provisions of the proposed rules) may not be available?

97. Are there other criteria that the Commissions should adopt as alternative means of satisfying the public information availability test in the proposed rules? If so, please explain what they are and what requirements the Commissions should impose to ensure the public availability of information regarding issuers of securities or securities in index CDS.

98. Should the proposed rules provide, solely with respect to CDS that may be entered into only between eligible contract participants, that the information availability test could be satisfied if the reference entity or the issuer of the security i) except in the case of issuing entities of asset-backed securities, provides information to the public or to

such eligible contract participant pursuant to rule 144A(d)(4) of the Securities Act; ii) except in the case of issuing entities of asset-backed securities, financial information is otherwise publicly available about the reference entity or the issuer of the security; or iii) in the case of asset-backed securities and issuing entities of asset-backed securities, financial information of the type and level included in public distribution reports for similar asset-backed securities about both the issuing entity and such asset-backed securities is publicly available? Why or why not? Please provide a detailed explanation and empirical data, to the extent feasible.

99. Should the proposed rules include additional or other criteria to determine whether an index is "narrow-based" with respect to index CDS? If so, what criteria should be included, and why?

100. Does the proposed treatment of index CDS whereby a payment is contemplated based on the default of a particular entity in the index rather than solely on the value of the index adequately address the federal regulatory interests under the federal securities laws and the Commodity Exchange Act?

101. Does the definition of "control" for purposes of identifying whether a reference entity or issuer is affiliated with another entity (ownership of 20 percent or more of an entity's or issuer's equity, or the ability to direct the voting of 20 percent or more of the entity's or issuer's voting equity) appropriately identify when affiliates are in a control relationship for these purposes? Why or why not? Should these thresholds be higher or lower? Please provide supporting data and/or analysis. Should issuing entities of asset-backed securities be considered separate reference entities or issuers for purposes of the proposed criteria? If not, why not? Are there circumstances under which issuing

entities of asset-backed securities should not be considered separate reference entities or issuers for purposes of the proposed criteria? Why or why not?

102. Are there other categories or types of CDS that proposed rules 1.3(zzz) and (aaaa) and proposed rules 3a68-1a and 3a68-1b do not address or that require additional clarification regarding their treatment under the Dodd-Frank Act? If so, please provide a detailed description of any such categories or types of CDS, as well as any analysis, supported by empirical data to the extent feasible, of what clarification is necessary.

103. Are there other categories of event-type contracts relating to issuers of securities that require additional clarification regarding their treatment under the Dodd-Frank Act? If so, please provide a detailed explanation of the types of contracts and why the proposed rules should apply to such other event-type contracts.

4. Security Indexes.

The Dodd-Frank Act defines the term "index" as "an index or group of securities, including any interest therein or based on the value thereof."[244] The Commissions are proposing guidance as to how to determine when a portfolio of securities is a narrow-based or broad-based security index and the circumstances in which changes to the

[244] See section 3(a)(68)(E) of the Exchange Act, 15 U.S.C. 78c(a)(68)(E).

composition of a security index (including a portfolio of securities)[245] underlying a Title VII instrument would affect the characterization of such Title VII instrument.[246]

In most cases, a security index is designed to reflect the performance of a market or sector by reference to representative securities or interests in securities. There are a number of well-known security indexes established and maintained by recognized index providers currently in the market.[247] The Commissions understand, however, that instead of using these established indexes, market participants may enter into a Title VII instrument where the underlying reference of the Title VII instrument is a portfolio of securities selected by the counterparties or created by a third-party index provider at the behest of one or both counterparties. In some cases, the Title VII instrument may give one or both of the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), discretionary authority to change the composition of the security portfolio, including, for example, by adding or removing securities in the security portfolio on an "at-will" basis during the term of the Title VII instrument.[248] The Commissions believe that where the counterparties, either directly or

245 A "portfolio" of securities could be a group of securities and therefore an "index" for purposes of the Dodd-Frank Act. To the extent that changes are made to the securities underlying the Title VII instrument and each such change is individually confirmed, then those substituted securities would not be part of a security index as defined in the Dodd-Frank Act, and therefore a Title VII instrument on each of those substituted securities would be a security-based swap.

246 Solely for purposes of the discussion in this section, the terms "security index" and "security portfolio" are intended to include either securities or the issuers of securities.

247 For instance, the S&P 500® is an index that gauges the large cap U.S. equities market.

248 Alternatively, counterparties may enter into Title VII instruments where a third-party investment manager selects an initial portfolio of securities and has discretionary authority to change the composition of the security portfolio in accordance with guidelines agreed upon with the counterparties. Such security portfolios would be treated

indirectly (e.g., through an investment adviser or through the third-party index provider), have this discretionary authority to change the composition or weighting of securities in a security portfolio, that security portfolio should be treated as a narrow-based security index, and that therefore a Title VII instrument on that security portfolio would be a security-based swap.[249]

The Commissions believe, however, that not all changes that occur to the composition or weighting of a security index underlying a Title VII instrument will always result in that security index being treated as a narrow-based security index. Many security indexes are constructed and maintained by an index provider pursuant to a published methodology.[250] For instance, the various Standard & Poor's security indexes

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as narrow-based security indexes with Title VII instruments on those security portfolios being security-based swaps.

249 The Commissions understand that a security portfolio could be labeled as such or could just be an aggregate of individual Title VII instruments documented, for example, under a master agreement or by amending an annex of securities attached to a master trade confirmation. If the security portfolio were created by aggregating individual Title VII instruments, each Title VII instrument would need to be evaluated in accordance with the proposed guidance to determine whether it is a swap or a security-based swap. For the avoidance of doubt, if the counterparties to a Title VII instrument exchanged payments under that Title VII instrument based on a security index that was itself created by aggregating individual security-based swaps, such Title VII instrument would be a security-based swap. See discussion supra part III.D.

250 See, e.g., NASDAQ, "NASDAQ-100 Index" ("The NASDAQ-100 Index is calculated under a modified capitalization-weighted methodology. The methodology is expected to retain in general the economic attributes of capitalization-weighting while providing enhanced diversification. To accomplish this, NASDAQ will review the composition of the NASDAQ-100 Index on a quarterly basis and adjust the weightings of Index components using a proprietary algorithm, if certain pre-established weight distribution requirements are not met."), available at http://dynamic.nasdaq.com/dynamic/nasdaq100_activity.stm,

are reconstituted and rebalanced as needed and on a periodic basis pursuant to published index criteria.[251]

In addition, counterparties to a Title VII instrument frequently agree to use as the underlying reference of a Title VII instrument a security index based on predetermined criteria where the security index composition or weighting may change as a result of the occurrence of certain events specified in the Title VII instrument at execution, such as "succession events." Counterparties to a Title VII instrument also may use a predetermined self-executing formula to make other changes to the composition or weighting of a security index underlying a Title VII instrument. In either of these situations, the composition of a security index may change pursuant to predetermined criteria or predetermined self-executing formulas without the Title VII instrument counterparties, their agents, or third-party index providers having any direct or indirect discretionary authority to change the security index.

In general, and by contrast to Title VII instruments in which the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), have the discretion to change the composition or weighting of the referenced security index, where there is an underlying security index for which there are predetermined criteria or a predetermined self-executing formula for adjusting the security index that are not subject to change or modification through the life of the Title VII instrument and that are set forth in the Title VII instrument at execution (regardless

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[251] Information regarding security indexes and their related methodologies may be widely available to the general public or restricted to licensees in the case of proprietary or "private label" security indexes. Both public and private label security indexes are frequently subject to intellectual property protection.

of who establishes the criteria or formula), a Title VII instrument on such underlying security index would be on a broad-based or narrow-based security index, depending on the composition and weighting of the underlying security index. Subject to the interpretation discussed below regarding security indexes that may shift from being a narrow-based security index or broad-based security index during the life of an existing Title VII instrument,[252] the characterization of a Title VII instrument based on a security index as either a swap or a security-based swap would depend on the characterization of the security index using the above interpretation.[253]

Request for Comment:

104. The Commissions request comment on whether there are additional or other criteria that would be appropriate in determining whether a security index or security portfolio would constitute a narrow-based security index for purposes of the definitions of the terms "swap" and "security-based swap." Please discuss any criteria in detail and provide any supporting data where relevant.

105. What are the ways in which Title VII instruments involving security portfolios are structured, including changes in security portfolio composition?

106. Should "discretionary authority to change" by the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), be a determinative factor for whether a security portfolio should be treated as a narrow-based security index? Why or why not? Are there Title VII instruments where the underlying reference is a security portfolio where counterparties may directly or

252 As discussed further below, the Commissions are concerned about the potential use of security indexes to game the narrow-based security index definition.

253 See supra note 249 regarding the aggregation of separate trades.

indirectly (e.g., through an investment manager or the third-party provider) exercise discretionary authority to change the composition of the security portfolio that should not be considered security-based swaps? Why or why not? Please provide a detailed explanation of such Title VII instruments, the means by which, and why, the composition of the underlying security portfolio are established and subsequently changed, and for what purpose such Title VII instruments are used.

107. Should a security index, where changes to the composition are not subject to discretionary authority but instead may be made pursuant to predetermined criteria or a predetermined self-executing formula set forth in the Title VII instrument at execution, be considered either a broad-based security index or a narrow-based security index, depending on its constitution? Why or why not? Are changes pursuant to such predetermined criteria or formulas common? How frequently do such changes occur? What sorts of events trigger such changes? Please provide a detailed explanation and empirical data, to the extent feasible.

108. Are the terms "predetermined criteria" and "predetermined self-executing formula" clear? Why or why not? If not, what alternative or additional guidance should be provided to clarify under what circumstances changes to the composition of a security index underlying a Title VII instrument may be made without being considered "at will" or discretionary changes by the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), that would result in the security index being treated as a narrow-based security index and the Title VII instrument being a security-based swap? Are there specific additional criteria, restrictions, or parameters that should be considered? If so, please provide a detailed explanation

regarding such criteria, restrictions, or parameters, including the types of changes that should or should not be permitted.

109. Are there specific methodologies or criteria, agreed to at or prior to the execution of a Title VII instrument, for changing the composition of an underlying security index, that should be explicitly addressed by the Commissions in providing the proposed guidance regarding security indexes? If so, please provide a detailed explanation of those methodologies or criteria and what additional guidance is necessary.

110. Would restrictions on the frequency of changes to the composition of a security index underlying a Title VII instrument be useful in determining whether the underlying security index should be treated as a narrow-based security index? If so, please provide a detailed explanation of what restrictions should apply and why, as well as empirical data to the extent feasible.

5. Evaluation of Title VII Instruments on Security Indexes That Move from Broad-Based to Narrow-Based or Narrow-Based to Broad-Based.

a) In General.

As discussed above, the determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made at the execution of the Title VII instrument.[254] If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument would not change from its initial characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF,

[254] See discussion supra part III.A.

FBOT, security-based SEF, or NSE. For example, if two counterparties enter into a swap based on a broad-based security index, and three months into the life of the swap the security index underlying that Title VII instrument migrates from being broad-based to being narrow-based, the Title VII instrument would remain a swap for the duration of its life and would not be recharacterized as a security-based swap.

If the material terms of a Title VII instrument are amended or modified during its life, the Commissions would view the amended or modified Title VII instrument as a new Title VII instrument.[255] As a result, the characteristics of the underlying security index must be reassessed at the time of such an amendment or modification to determine whether the security index has migrated from broad-based to narrow-based or vice versa. If the security index has migrated, then the characterization of the amended or modified Title VII instrument would be determined by evaluating the characterization of the underlying security index at the time the Title VII instrument is amended or modified. Similarly, if a security index has migrated from broad-based to narrow-based or vice versa, any new Title VII instrument based on that security index would be characterized pursuant to an evaluation of the underlying security index at the execution of that new Title VII instrument.

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255 For example, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to track the performance of only 8 of those 12 securities, the Commissions would view the amended or modified Title VII instrument as a new Title VII instrument. Conversely, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to reflect the replacement of a departing "key person" of a hedge fund that is a counterparty to the Title VII instrument with a new "key person," the Commissions would not view the amended or modified Title VII instrument as a new Title VII instrument because the amendment or modification is not to a material term of the Title VII instrument. Because it would be a new Title VII instrument, any regulatory requirements regarding new Title VII instruments would apply.

The Commissions are proposing guidance regarding circumstances in which the character of a security index on which a Title VII instrument is based changes according to predetermined criteria or a predetermined self-executing formula set forth in the Title VII instrument (or in a related or other agreement entered into by the counterparties or a third-party index provider to the Title VII instrument) at execution. Where at the time of execution such criteria or such formula would cause the underlying broad-based security index to become or assume the characteristics of a narrow-based security index or vice versa during the duration of the instrument,[256] then the characterization of the Title VII instrument based on such security index would be a mixed swap during the entire life of the Title VII instrument.[257] Although at certain points during the life of the Title VII instrument the underlying security index would be broad-based and at other points the underlying security index would be narrow-based, the Commissions believe that regulating such a Title VII instrument as a mixed swap from the execution of the Title VII instrument and throughout its life reflects the appropriate characterization of a Title VII instrument based on a security index that migrates pursuant to predetermined criteria or a predetermined self-executing formula.

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256 Thus, for example, if a predetermined self-executing formula agreed to by the counterparties of a Title VII instrument at or prior to the execution of the Title VII instrument provided that the security index underlying the Title VII instrument would decrease from 20 to 5 securities after six months, such that the security index would become narrow-based as a result of the reduced number of securities, then the Title VII instrument would be a mixed swap at its execution. The characterization of the Title VII instrument as a mixed swap would not change during the life of the Title VII instrument.

257 As discussed above in part III.G.4, to the extent a Title VII instrument permits "at will" substitution of an underlying security index, however, as opposed to the use of predetermined criteria or a predetermined self-executing formula, the Title VII instrument would be a security-based swap at its execution and throughout its life regardless of whether the underlying security index was narrow-based at the execution of the Title VII instrument.

The Commissions believe that this guidance regarding the use of predetermined criteria or a predetermined self-executing formula would prevent potential gaming of the Commissions' guidance regarding security indexes and prevent potential regulatory arbitrage based on the migration of a security index from broad-based to narrow-based or vice versa. In particular, the Commissions note that predetermined criteria and predetermined self-executing formulas can be constructed in ways that take into account the characteristics of a narrow-based security index and prevent a narrow-based security index from becoming broad-based and vice versa.

b) Title VII Instruments on Security Indexes Traded on Designated Contract Markets, Swap Execution Facilities, Foreign Boards of Trade, Security-Based Swap Execution Facilities, and National Securities Exchanges.

The Commissions recognize that security indexes underlying Title VII instruments that are traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs raise particular issues if an underlying security index migrates from broad-based to narrow-based or vice versa. The characterization of an exchange-traded Title VII instrument at its execution, as explained above, would not change through the life of the Title VII instrument, regardless of whether the underlying security index migrates from broad-based to narrow-based or vice versa. Accordingly, a market participant who enters into a swap on a broad-based security index traded on or subject to the rules of a DCM, SEF or FBOT that migrates from broad-based to narrow-based may hold that position until the swap's expiration without any change in regulatory responsibilities, requirements, or obligations, and similarly a market participant who enters into a security-based swap on a narrow-based security index traded on a security-based SEF or NSE may hold that position until the security-based swap's expiration without any change in regulatory responsibilities, requirements, or obligations.

However, in the absence of any action by the Commissions, if the market participant wants to offset the swap or enter into a new swap on the DCM, SEF or FBOT where the underlying security index has migrated from broad-based to narrow-based, or to offset the security-based swap or enter into a new security-based swap on a security-based SEF or NSE where the underlying security index has migrated from narrow-based to broad-based, the participant would be prohibited from doing so. That is because swaps may trade only on DCMs, SEFs, and FBOTs, and security-based swaps may trade only on registered NSEs and security-based SEFs.[258] The Commissions believe it is important to address how to treat Title VII instruments traded on trading platforms where the underlying security index migrates from broad-based to narrow-based or narrow-based to broad-based so that market participants will know where such Title VII instruments may be traded and can avoid potential disruption of their ability to offset or enter into new Title VII instruments on trading platforms when such migration occurs. The Commissions are proposing rules accordingly.[259]

258 If a swap were based on a security index that migrated from broad-based to narrow-based, a DCM, SEF, or FBOT could no longer offer the Title VII instrument because it would be a security-based swap. Similarly, if a security-based swap were based on a security index that migrated from narrow-based to broad-based, a security-based SEF or NSE could no longer offer the Title VII instrument because it would be a swap.

259 The proposed rules apply only to the particular Title VII instrument that is traded on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. To the extent that a particular Title VII instrument is not traded on such a trading platform (even if another Title VII instrument of the same class or type is traded on such a trading platform) the proposed rules would not apply to that particular Title VII instrument.

Congress and the Commissions addressed a similar issue in the context of security futures, where the security index on which a future is based may migrate from broad-based to narrow-based or vice versa. Congress provided in the definition of "narrow-based security index" in both the CEA and the Exchange Act[260] for a tolerance period ensuring that, under certain conditions, a futures contract on a broad-based security index traded on a DCM may continue to trade, even when the index temporarily assumes characteristics that would render it a narrow-based security index under the statutory definition.[261] In general, an index is subject to this tolerance period, and therefore is not a narrow-based security index, if: i) a futures contract on the index traded on a DCM for at least 30 days as a futures contract on a broad-based security index before the index assumed the characteristics of a narrow-based security index and ii) the index does not retain the characteristics of a narrow-based security index for more than 45 business days over 3 consecutive calendar months. Pursuant to these statutory provisions, if the index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, the index is excluded from the definition of the term "narrow-based security index" for the following 3 calendar months as a grace period.

The Commissions believe a similar tolerance period should apply to swaps traded on DCMs, SEFs, and FBOTs and security-based swaps traded on security-based

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260 CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii).

261 By joint rules, the Commissions have provided that "[w]hen a contract of sale for future delivery on a security index is traded on or subject to the rules of a foreign board of trade, such index shall not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market . . . ." See CFTC rule 41.13, 17 CFR 41.13, and rule 3a55-3 under the Exchange Act, 17 CFR 240.3a55-3. Accordingly, the statutory tolerance period rules applicable to futures on security indexes traded on DCMs apply to futures traded on FBOTs as well.

SEFs and NSEs. Accordingly, the Commissions are proposing rules providing for tolerance periods for swaps that are traded on DCMs, SEFs, or FBOTs and for security-based swaps traded on security-based SEFs and NSEs.

Under paragraph (2)(i)(A) of proposed rule 1.3(yyy) under the CEA and paragraph (b)(1)(i) of proposed rule 3a68-3 under the Exchange Act, to be subject to the tolerance period, a security index underlying a swap executed on or subject to the rules of a DCM, SEF, or FBOT must not have been a narrow-based security index[262] during the first 30 days of trading.[263] If the index becomes narrow-based during the first 30 days of trading, paragraph (2)(i)(B) of proposed rule 1.3(yyy) under the CEA and paragraph (b)(1)(ii) of proposed rule 3a68-3 under the Exchange Act provide that the index must not have been a narrow-based security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index.[264] If either of these alternatives are met, paragraph (2)(ii) of proposed rule 1.3(yyy) under the CEA and paragraph (b)(2) of proposed rule 3a68-3 under the Exchange Act provide that the index will not be a narrow-based security index if it has been a narrow-based security index for no more than 45 business days over 3 consecutive calendar months. Paragraph (2) of proposed rule 1.3(yyy) under the CEA

262 For purposes of the proposed rules, the term "narrow-based security index" shall also mean "issuers of securities in a narrow-based security index." See supra part III.G.3.b) (discussing the proposed rules defining "issuers of securities in a narrow-based security index").

263 This provision is consistent with the provisions of the CEA and the Exchange Act applicable to futures contracts on security indexes. CEA section 1a(35)(B)(iii)(I), 7 U.S.C. 1a(35)(B)(iii)(I); section 3(a)(55)(C)(iii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(I).

264 This alternative test is the same as the alternative test applicable to futures contracts in CEA rule 41.12, 17 CFR 41.12 and rule 3a55-2 under the Exchange Act, 17 CFR 240.3a55-2.

and paragraph (b) of proposed rule 3a68-3 under the Exchange Act apply solely for purposes of swaps traded on or subject to the rules of a DCM, SEF, or FBOT.

Similarly, paragraph (3) of proposed rule 1.3(yyy) under the CEA and paragraph (c) of proposed rule 3a68-3 under the Exchange Act provide a tolerance period for security-based swaps traded on security-based SEFs or NSEs. Under paragraph (3)(i)(A) of proposed rule 1.3(yyy) under the CEA and paragraph (c)(1)(i) of proposed rule 3a68-3 under the Exchange Act, to be subject to the tolerance period, a security index underlying a security-based swap executed on a security-based SEF or NSE must have been a narrow-based security index during the first 30 days of trading. If the index becomes broad-based during the first 30 days of trading, paragraph (3)(i)(B) of proposed rule 1.3(yyy) under the CEA and paragraph (c)(1)(ii) of proposed rule 3a68-3 under the Exchange Act provide that the index must have been a non-narrow-based security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index. If either of these alternatives are met, paragraph (3)(ii) of proposed rule 1.3(yyy) under the CEA and paragraph (c)(2) of proposed rule 3a68-3 under the Exchange Act provide that the index will be a narrow-based security index if it has been a security index that is not narrow-based for no more than 45 business days over 3 consecutive calendar months.[265] Paragraph (3) of proposed rule 1.3(yyy) under the CEA and paragraph (c) of proposed

265 These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. CEA section 1a(35)(B)(iii)(II), 7 U.S.C. 1a(35)(B)(iii)(II); section 3(a)(55)(C)(iii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(II).

rule 3a68-3 under the Exchange Act apply solely for purposes of security-based swaps traded on security-based SEFs or NSEs.

The Commissions are proposing that, once the tolerance period under the proposed rules has ended, there would be a grace period during which a Title VII instrument based on a security index that has migrated from broad-based to narrow-based or vice versa would be able to trade on the platform on which Title VII instruments based on such security index were trading before the security index migrated and can also, during such period, be cleared. Paragraph (4)(i) of proposed rule 1.3(yyy) under the CEA and paragraph (d)(1) of proposed rule3a68-3 under the Exchange Act would provide for an additional 3-month grace period applicable to a security index that becomes narrow-based for more than 45 business days over 3 consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs. During the grace period, such an index would not be considered a narrow-based security index. Paragraph (4)(ii) of proposed rule 1.3(yyy) under the CEA and paragraph (d)(2) of proposed rule3a68-3 under the Exchange Act would apply the same grace period to a security-based swap on a security index that becomes broad-based for more than 45 business days over 3 consecutive calendar months, solely with respect to security-based swaps that are traded on a security-based SEF or NSE. During the grace period, such an index would not be considered a broad-based security index.[266] As a result, this proposed

266 These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. See CEA section 1a(35)(D), 7 U.S.C. 1a(35)(D); section 3(a)(55)(E) of the Exchange Act, 15 U.S.C. 78c(a)(55)(E).

rule would provide sufficient time for the migrated Title VII instrument to satisfy listing and clearing requirements applicable to swaps or security-based swaps, as appropriate.

There would be no overlap between the tolerance and the grace periods under the proposed rules and no "re-triggering" of the tolerance period. For example, if a security index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs, but as a result of the proposed rules is not considered a narrow-based security index during the grace period, the tolerance period provisions would not apply, even if the security-index migrated temporarily during the grace period. After the grace period has ended, a security index would need to satisfy anew the requirements under the proposed rules regarding the tolerance period in order to trigger a new tolerance period.

The Commissions note that the proposed rules would not result in the recharacterization of any outstanding Title VII instruments. In addition, the proposed tolerance and grace periods would apply only to Title VII instruments that are traded on or subject to the rules of DCMs, SEFs, FBOTs, security-based SEFs, and NSEs.

Request for Comment:

The Commissions request comment on all aspects of proposed rules 1.3(yyy) under the CEA and proposed rule 3a68-3 under the Exchange Act, including the following:

111. The Commissions request comment regarding whether the term "narrow-based security index" as defined in the CEA and the Exchange Act[267] requires further definition solely in the context of Title VII instruments.

112. Are there particular types of Title VII instruments that require additional guidance as to how the narrow-based security index definition applies? If so, which types of Title VII instruments? How should the definition apply to them? Please provide a detailed explanation of such Title VII instruments and the additional guidance that would be appropriate.

113. Does the proposed guidance effectively address security indexes that migrate from broad-based to narrow-based and vice versa? Why or why not? If not, what additional or alternative requirements would be appropriate, and why?

114. Will the proposed limitations regarding the use of predetermined criteria or predetermined self-executing formulas for Title VII instruments effectively prevent gaming of the proposed rules and potential regulatory arbitrage based on the migration of a security index or security portfolio from broad-based to narrow-based or vice versa? Why or why not? If not, please provide a detailed explanation of why not, and what additional or alternative limitations would do so.

115. Should the standard pursuant to which a Title VII instrument would be a mixed swap during the entire life of the Title VII instrument require instead that the predetermined criteria or predetermined self-executing formula be constructed in such a manner that a broad-based security index or security portfolio would be reasonably likely

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267 CEA sections 1a(35)(A) and (B), 7 U.S.C. 1a(35)(A) and (B); section 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C).

to become or assume the characteristics of a narrow-based security index or security portfolio, or vice versa? Why or why not? Are there additional or alternative standards that should be used in determining when a Title VII instrument would be a mixed swap during the entire life of the Title VII instrument? If so, please provide a detailed explanation of such standards and why they would be effective.

116. Do the proposed tolerance period rules appropriately address security indexes that temporarily change from broad-based to narrow-based, and from narrow-based to broad-based, in the context of Title VII instruments that are executed on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE? Why or why not? If not, how should the proposed tolerance period rules be modified?

117. Should the "grace period" applicable to Title VII instruments executed on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE regarding a security index that becomes narrow-based or broad-based, respectively, for more than 45 business days over 3 consecutive calendar months be modified? Why or why not? If so, what modifications should be made?

118. What would be the impact of the proposed rules on market participants with open swap or security-based swap positions if the security index underlying a swap were to become narrow-based or if the security index underlying a security-based swap were to become broad-based? Should market participants be allowed to liquidate their swaps or security-based swaps prior to expiration but after the grace period? If so, how would the listing market restrict trading for liquidation only?

H. Method of Settlement of Index CDS.

The method that the parties have chosen or use to settle an index CDS following the occurrence of a credit event under such index CDS also can affect whether such index

CDS would be a swap, a security-based swap, or both (i.e., a mixed swap). The Commissions believe that if an index CDS that is not based on a narrow-based security index under the Commissions' proposed rules includes a mandatory physical settlement provision that would require the delivery of, and therefore the purchase and sale of, a non-exempted security[268] or a loan in the event of a credit event, such an index CDS would be a mixed swap.[269] Conversely, the Commissions believe that if an index CDS that is not based on a narrow-based security index under the Commissions' proposed rules includes a mandatory cash settlement[270] provision, such index CDS would be a swap, and not a security-based swap or a mixed swap, even if the cash settlement were based on the value of a non-exempted security or a loan.

The Commissions believe that an index CDS that is not based on a narrow-based security index under the Commissions' proposed rules and that provides for cash

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268 The Commissions note that section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C), provides that "[t]he term "security-based swap" does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option."

269 The Commissions' views as to the legal basis for such a conclusion differ. The SEC also notes that there must either be an effective registration statement covering the transaction or an exemption under the Securities Act would need to be available for such physical delivery of securities and compliance issues under the Exchange Act would also need to be considered.

The Commissions are aware that the 2003 Definitions, supra note 35, include "Cash Settlement" as a defined term and that such "Settlement Method" (also a defined term in the 2003 Definitions) works differently than auction settlement pursuant to the "Big Bang Protocol" or "Auction Supplement" (each as defined below). The Commissions' use of the term "cash settlement" in this section includes "Cash Settlement," as defined in the 2003 Definitions, and auction settlement, as described in the "Big Bang Protocol" or "Auction Supplement."

settlement in accordance with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 Definitions (the "Auction Supplement") or with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol ("Big Bang Protocol")[271] would be a swap, and would not be considered a security-based swap or a mixed swap solely because the determination of the cash price to be paid is established through a securities or loan auction.[272] In 2009, auction settlement, rather than physical settlement, became the default method of settlement for, among other types of CDS, index CDS on corporate issuers of securities.[273] The amount of the cash settlement is determined through an auction triggered by the occurrence of a credit event.[274] The Auction Supplement "hard wired" the mechanics of credit event auctions into the 2003 Definitions.[275] The Commissions understand that the credit event auction process that is part of the ISDA terms works as follows:

Following the occurrence of a credit event under a CDS, a determinations committee ("DC") established by ISDA, following a request by any party to a credit

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271 See Int'l Swaps and Derivatives Ass'n, Inc., "2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol," available at http://www.isda.org/bigbangprot/docs/Big-Bang-Protocol.pdf.

272 The possibility that such index CDS may, in fact, be physically settled if an auction is not held or if the auction fails would not affect the characterization of the index CDS.

273 The Commissions understand that the Big Bang Protocol is followed for index CDS involving corporate debt obligations but is not followed for index CDS based on asset-backed securities, loan-only CDS, and certain other types of CDS contracts. To the extent that such other index CDS contain auction procedures similar to the auction procedures for corporate debt to establish the cash price to be paid, the Commissions also would not consider such other index CDS that are not based on narrow-based security indexes under the Commissions' proposed rules to be mixed swaps.

274 The Commissions understand that other conditions may need to be satisfied as well for an auction to be held.

275 See supra note 35.

derivatives transaction that is subject to the Big Bang Protocol or Auction Supplement, will determine, among other matters: i) whether and when a credit event occurred; ii) whether or not to hold an auction to enable market participants to settle those of their credit derivatives transactions covered by the auction; iii) the list of deliverable obligations of the relevant reference entity; and iv) the necessary auction specific terms. The credit event auction takes place in two parts. In the first part of the auction, dealers submit physical settlement requests, which are requests to buy or sell any of the deliverable obligations (based on the dealer's needs and those of its counterparties), and an initial market midpoint price is created based on dealers' initial bids and offers. Following the establishment of the initial market midpoint, the physical settlement requests are then calculated to determine the amount of open interest.

The aggregate amount of open interest is the basis for the second part of the auction. In the second part of the auction, dealers and investors can determine whether to submit limit orders and the levels of such limit orders. The limit orders, which are irrevocable, have a firm price in addition to size and whether it is a buy or sell order. The auction is conducted as a "dutch" auction, in which the open buy interests and open sell interests are matched.[276] The final price of the auction is the last limit order used to

[276] The second part of the credit event auction process involves offers and sales of securities that must be made in compliance with the provisions of the Securities Act and the Exchange Act. First, the submission of a physical settlement request constitutes an offer by the counterparty to either buy or sell any one of the deliverable obligations in the auction. Second, the submission of the irrevocable limit orders by dealers or investors are sales or purchases by such persons at the time of submission of the irrevocable limit order. Through the auction mechanism, where the open interest (which represents physical settlement requests) is matched with limit orders, buyers and sellers are matched. Finally, following the auction and determination of the final price, the counterparty who has submitted the physical delivery request decides which of the deliverable obligations will be delivered to satisfy the limit order in exchange for the final

match against the open interest. The final price in the auction is the cash price used for purposes of calculating the settlement payments in respect of the orders to buy and sell the deliverable obligations and it is also used to determine the cash settlement payment under the CDS.

I. Security-Based Swaps as Securities under the Exchange Act and Securities Act.

Pursuant to the Dodd-Frank Act, a security-based swap is defined as a "security" under the Exchange Act[277] and Securities Act.[278] As a result, security-based swaps are subject to the Exchange Act and the Securities Act and the rules and regulations promulgated thereunder.[279] To the extent that security-based swaps differ from more traditional securities products, however, the SEC is soliciting comment on whether additional guidance may be necessary regarding the application of certain provisions of the Exchange Act and the Securities Act, and the rules and regulations promulgated thereunder, to security-based swaps.

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price. The sale of the securities in the auction occurs at the time the limit order is submitted, even though the identification of the specific deliverable obligation does not occur until the auction is completed.

277 See section 761(a)(2) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 3a(10) of the Exchange Act, 15 U.S.C. 78c(a)(10)).

278 See section 768(a)(1) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1)).

279 Sections 761(a)(3) and (4) of the Dodd-Frank Act amend sections 3(a)(13) and (14) of the Exchange Act, 15 U.S.C. 78c(a)(13) and (14), and section 768(a)(3) of the Dodd-Frank Act adds section 2(a)(18) to the Securities Act, 15 U.S.C. 77b(a)(18), to provide that the terms "purchase" and "sale" of a security-based swap shall mean the "the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require."

119. Are there Exchange Act or Securities Act provisions, or rules and regulations promulgated thereunder, that contemplate application to cash market securities products or other securities products for which additional guidance may be necessary when applied to security-based swaps? If so, which provisions, and why? Please provide detailed analysis and empirical data, to the extent feasible.

120. What additional guidance or modifications would be necessary to any such provisions in order to address the application of these provisions to security-based swaps while still achieving the regulatory purposes of those provisions?

IV. Mixed Swaps.

A. Scope of the Category of Mixed Swap.

The category of mixed swap is described, in both the definition of the term "security-based swap" in the Exchange Act and the definition of the term "swap" in the CEA, as a security-based swap that is also:

> based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(ii)(III) [of section 3(a)(68) of the Exchange Act]).[280]

A mixed swap, therefore, is both a security-based swap and a swap.[281]

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280 Section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(a)(68)(D); CEA section 1a(47)(D), 7 U.S.C. 1a(47)(D).

281 Id. The exclusion from the definition of the term "swap" for security-based swaps does not include security-based swaps that are mixed swaps. See CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x).

The Commissions believe that the scope of mixed swaps is, and is intended to be, narrow. Title VII establishes robust and largely parallel regulatory regimes for both swaps and security-based swaps and directs the Commissions to jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of the Dodd-Frank Act.[282] More generally, the Commissions believe the category of mixed swap was designed so that there would be no gaps in the regulation of swaps and security-based swaps. Therefore, in light of the statutory scheme created by the Dodd-Frank Act for swaps and security-based swaps, the Commissions believe the category of mixed swap covers only a small subset of Title VII instruments.[283]

For example, a Title VII instrument in which the underlying references are the value of an oil corporation stock and the price of oil would be a mixed swap. Similarly, a Title VII instrument in which the underlying reference is a portfolio of both securities (assuming the portfolio is not an index or, if it is an index, that the index is narrow-based) and commodities would be a mixed swap. Mixed swaps also would include certain Title VII instruments called "best of" or "out performance" swaps that require a payment based on the higher of the performance of a security and a commodity (other than a security).[284] As discussed elsewhere in this release, the Commissions also believe that certain Title VII instruments may be mixed swaps if they meet specified conditions.

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282 See section 712(a)(8) of the Dodd-Frank Act.

283 See Morgan Stanley Letter (expressing the view that "the universe of mixed swaps should be relatively small"); Letter from Timothy W. Cameron, Esq., Managing Director, Asset Management Group, Securities Industry and Financial Markets Association ("SIFMA Letter") (suggesting that the scope of products included in the mixed swap category should be limited to "avoid unnecessary and duplicative regulation").

284 See Cleary Letter (providing as examples of mixed swaps, "a swap based on the out-performance of gold, oil or another commodity relative to a security or narrow-based

The Commissions also believe that the use of certain market standard agreements in the documentation of Title VII instruments should not in and of itself transform a Title VII instrument into a mixed swap. For example, many instruments are documented by incorporating by reference market standard agreements. Such agreements typically set out the basis of establishing a trading relationship with another party but are not, taken separately, a swap or security-based swap. These agreements also include termination and default events relating to one or both of the counterparties; such counterparties may or may not be entities that issue securities.[285] The Commissions believe that the term "any agreement . . . based on . . . the occurrence of an event relating to a single issuer of a security," as provided in the definition of the term "security-based swap," was not intended to include such termination and default events relating to counterparties included in standard agreements that are incorporated by reference into a Title VII instrument.[286] Therefore, an instrument would not be simultaneously a swap and a security-based swap (and thus not a mixed swap) simply by virtue of having incorporated by reference a standard agreement, including default and termination events relating to counterparties to the Title VII instrument.

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security index," "a security-based swap with knock-out/knock-in events tied to the value of gold, oil or another commodity," and "[s]waps on indices or baskets that include narrow-based security index and physical commodity components"); Deutsche Bank Letter (indicating that "best-of" swaps should be treated as mixed swaps); Morgan Stanley Letter ("An example of a mixed swap might be a contract under which one party takes long exposure to the common stock of a US corporation while simultaneously taking short exposure to the price of gold.").

285 Those standard events include inter alia bankruptcy, breach of agreement, cross default to other indebtedness, and misrepresentations.

286 See section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

The Commissions request comment on the following:

121. Are there other examples of Title VII instruments that should, or should not, be included within the mixed swap category?

122. How frequently, and for what purposes, do market participants use mixed swaps?

123. Can, and should, the economic goals of mixed swaps be accomplished using a combination of separate Title VII instruments, none of which would need to constitute a mixed swap? What problems, if any, would arise from the "disaggregation" of mixed swaps?

B. Regulation of Mixed Swaps.

1. Introduction.

Paragraph (a) of proposed rule 1.9 under the CEA and proposed rule 3a68-4 under the Exchange Act would define a "mixed swap" in the same manner as the term is defined in both the CEA and the Exchange Act. The Commissions are proposing two rules to address the regulation of mixed swaps. First, paragraph (b) of proposed rule 1.9 under the CEA and proposed rule 3a68-4 under the Exchange Act would provide a regulatory framework with which parties to bilateral uncleared mixed swaps (i.e., mixed swaps that are neither executed on or subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT nor cleared through a DCO or clearing agency), as to which at least one of the parties is dually registered with both Commissions, would need to comply. Second, paragraph (c) of the proposed rules would establish a process for persons to request that the Commissions issue a joint order permitting such persons (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap)[287] to comply, as to parallel provisions[288] only, with specified parallel provisions of either the CEA or the Exchange Act, and related rules and regulations (collectively "specified parallel provisions"), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

2. Bilateral Uncleared Mixed Swaps Entered Into by Dually-Registered Dealers or Major Participants.

Swap dealers and major swap participants will be comprehensively regulated by the CFTC and security-based swap dealers and major security-based swap participants will be comprehensively regulated by the SEC.[289] The Commissions recognize that there may be differences in the requirements applicable to swap dealers and security-based swap dealers, or major swap participants and major security-based swap participants, such that dually-registered market participants may be subject to potentially conflicting or duplicative regulatory requirements when they engage in mixed swap transactions. In order to assist market participants in addressing such potentially conflicting or duplicative requirements, the Commissions are proposing rules that would permit dually-registered swap dealers and security-based swap dealers and dually-registered major swap participants and major security-based swap participants to comply with an

[287] All references to Title VII instruments in this part IV and in part VI shall include a class of such Title VII instruments as well. For example, a "class" of Title VII instrument would include instruments that are of similar character and provide substantially similar rights and privileges.

[288] For purposes of paragraph (b) of proposed rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act, "parallel provisions" means comparable provisions of the CEA and the Exchange Act that were added or amended by Title VII with respect to security-based swaps and swaps, and the rules and regulations thereunder.

[289] Section 712(a)(7)(A) of the Dodd-Frank Act requires the Commissions to treat functionally or economically similar entities in a similar manner.

alternative regulatory regime when they enter into certain mixed swaps under specified circumstances.

Accordingly, paragraph (b) of proposed rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act would provide that a bilateral uncleared mixed swap,[290] where at least one party is dually-registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant, would be subject to all applicable provisions of the federal securities laws (and SEC rules and regulations promulgated thereunder). The proposed rules also would provide that such mixed swaps would be subject to only the following provisions of the CEA (and CFTC rules and regulations promulgated thereunder):

- Examinations and information sharing: CEA sections 4s(f) and 8;[291]
- Enforcement: CEA sections 2(a)(1)(B), 4(b), 4b, 4c, 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b) and 23;[292]
- Reporting to an SDR: CEA section 4r;[293]
- Real-time reporting: CEA section 2(a)(13);[294]

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290 For purposes of the proposed rules, a "bilateral uncleared mixed swap" would be a mixed swap that: i) is neither executed on nor subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT; and ii) will not be submitted to a DCO or registered or exempt clearing agency to be cleared. To the extent that a mixed swap is subject to the mandatory clearing requirement (see CEA section 2(h)(1)(A), 7 U.S.C. 2(h)(1)(A), and section 3C(a)(1) of the Exchange Act) (and where a counterparty is not eligible to rely on the end-user exclusion from mandatory clearing requirement (see CEA section 2(h)(7), 7 U.S.C. 2(h)(7), and section 3C(g) of the Exchange Act)), this alternative regulatory treatment would not be available.

291 7 U.S.C. 6s(f) and 12, respectively.

292 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 9 and 15, 13b, 13a-1, 13a-2, 13, 13c(a), 13c(b), and 26, respectively.

293 7 U.S.C. 6r.

294 7 U.S.C. 2(a)(13).

- Capital: CEA section 4s(e);[295] and
- Position Limits: CEA section 4a.[296]

The Commissions believe that paragraph (b) of the proposed rules would address potentially conflicting or duplicative regulatory requirements for dually-registered dealers and major participants that are subject to regulation by both the CFTC and the SEC, while requiring dual registrants to comply with the regulatory requirements the Commissions believe are necessary to provide sufficient regulatory oversight for mixed swaps transactions entered into by such dual registrants. The CFTC also believes that paragraph (b) of the proposed rules would provide clarity to dually-registered dealers and major participants, who are subject to regulation by both the CFTC and the SEC, as to the requirements of each Commission that will apply to their bilateral uncleared mixed swaps.

Request for Comment:

124. The Commissions request comment generally on the foregoing proposed rules regarding the regulation of mixed swaps entered into by dually-registered swap or security-based swap dealers and major swap or security-based swap participants.

125. Does paragraph (b) of proposed rule 1.9 under the CEA and proposed rule 3a68-4 under the Exchange Act provide effective regulatory treatment for bilateral uncleared mixed swaps entered into by persons that are dually registered both as swap dealers or major swap participants with the CFTC and security-based swap dealers or

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[295] 7 U.S.C. 6s(e).

[296] 7 U.S.C. 6a.

major security-based swap participants with the SEC? If not, how should the proposed regulatory treatment be modified?

126. Are the enumerated sections of the CEA (and the regulations promulgated thereunder) that are reserved in paragraph (b) appropriate? Are there sections that should be withdrawn? Why or why not? Are there sections that should be added? Why or why not?

3. Regulatory Treatment for Other Mixed Swaps.

Because mixed swaps are both security-based swaps and swaps,[297] absent a joint rule or order by the Commissions permitting an alternative regulatory approach, persons who desire or intend to list, trade, or clear a mixed swap (or class thereof) would be required to comply with all the statutory provisions in the CEA and the Exchange Act (including all the rules and regulations thereunder) that were added or amended by Title VII with respect to swaps or security-based swaps.[298] Such dual regulation may not be appropriate in every instance and may result in potentially conflicting or duplicative regulatory requirements. However, before the Commissions can determine the appropriate regulatory treatment for mixed swaps (other than the treatment discussed above), the Commissions would need to understand better the nature of the mixed swaps that parties want to trade. Paragraph (c) of proposed rule 1.9 under the CEA and

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297 See supra note 10.

298 Because security-based swaps are also securities, compliance with the federal securities laws and rules and regulations thereunder (in addition to the provisions of the Dodd-Frank Act and the rules and regulations thereunder) would also be required. To the extent one of the Commissions has exemptive authority with respect to other provisions of the CEA or the federal securities laws and the rules and regulations thereunder, persons may submit separate exemptive requests or rulemaking petitions regarding those provisions to the relevant Commission.

proposed rule 3a68-4 under the Exchange Act would establish a process pursuant to which any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to the provisions of paragraph (b) (i.e., bilateral uncleared mixed swaps entered into by at least one dual registrant) may request the Commissions to publicly issue a joint order permitting such person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.[299]

Paragraph (c) of the proposed rules would further provide that a person submitting such a request to the Commissions must provide the Commissions with:

i) all material information regarding the terms of the specified, or specified class of, mixed swap;

ii) the economic characteristics and purpose of the specified, or specified class of, mixed swap;

iii) the specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof);

iv) an analysis of (1) the nature and purposes of the parallel provisions that are the subject of the request; (2) the comparability of such parallel provisions; and (3) the extent of any conflicts or differences between such parallel provisions; and

v) such other information as may be requested by either of the Commissions.

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299 Other than with respect to the specified parallel provisions with which such persons may be permitted to comply instead of complying with parallel provisions of both the CEA and the Exchange Act, any other provision of either the CEA or the federal securities laws that applies to swaps or security-based swaps will continue to apply.

This provision is intended to provide the Commissions with sufficient information regarding the mixed swap (or class thereof) and the proposed regulatory approach to make an informed determination regarding the appropriate regulatory treatment of the mixed swap (or class thereof).

Paragraph (c) of the proposed rules also would allow a person to withdraw a request regarding the regulation of a mixed swap at any time prior to the issuance of a joint order by the Commissions. This provision is intended to permit persons to withdraw requests that they no longer need. This, in turn, would save the Commissions time and staff resources.

Paragraph (c) would further provide that in response to a request pursuant to the proposed rules, the Commissions may jointly issue an order, after public notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. In determining the contents of such a joint order, the Commissions could consider, among other things, i) the nature and purposes of the parallel provisions that are the subject of the request; ii) the comparability of such parallel provisions; and iii) the extent of any conflicts or differences between such parallel provisions.

Finally, paragraph (c) of the proposed rules would require the Commissions, if they determine to issue a joint order pursuant to these rules, to do so within 120 days of receipt of a complete request (with such 120-day period being tolled during the pendency of a request for public comment on the proposed interpretation). If the Commissions do not issue a joint order within the prescribed time period, the proposed rules require that each Commission publicly provide the reasons for not having done so. Paragraph (c) makes clear that nothing in the proposed rules requires either Commission to issue a requested joint order regarding the regulation of a particular mixed swap (or class thereof).

These provisions are intended to provide market participants with a prompt review of requests for a joint order regarding the regulation of a particular mixed swap (or class thereof). The proposed rules also would provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested order or publicly state the reasons for not doing so.

Request for Comment:

127. Is the proposed procedure set forth in paragraph (c) appropriate? Should paragraph (c) of the proposed rules include a more detailed process for persons to request that the Commissions issue a joint order permitting such persons to comply, as to parallel provisions only, with specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act? If so, please provide a detailed explanation of what that process should include.

128. Is the information required by paragraph (c) in support of a request for a joint order appropriate? Are there specific economic characteristics that should be required? In particular, should requesting persons be required to provide the specified parallel provisions, and the reasons the person believes it would be appropriate to request

that regulatory treatment, as well as an analysis of i) the nature and purposes of the parallel provisions that are the subject of the request; ii) the comparability of such parallel provisions; and iii) the extent of any conflicts or differences between such parallel provisions? Why or why not? If not, please provide a detailed explanation, including what information requesting persons should be required to provide.

129. Is there additional or alternative information that the Commissions should require persons to submit in connection with a request regarding the regulation of particular mixed swaps (or class thereof)? If so, what additional or alternative information should be required?

130. Should persons be able to withdraw a request for a joint order regarding the regulation of a particular mixed swap (or class thereof)? Why or why not? Should there be additional requirements regarding such withdrawals? If so, what should they be?

131. Is the 120-day timeframe for issuance of a requested joint order provided for in paragraph (c) of proposed rule 1.9 under the CEA and proposed rule 3a68-4 under the Exchange Act appropriate? Is it too short or too long? Are the provisions for tolling this timeframe during a public comment period appropriate? Why or why not? Where the Commissions do not issue a joint order, is it appropriate that they each publicly provide the reasons for not doing so within the applicable timeframe? Why or why not?

V. Security-Based Swap Agreements.

A. Introduction.

SBSAs are swaps over which the CFTC has regulatory and enforcement authority but for which the SEC also has antifraud and certain other authority.[300] The term "security-based swap agreement" is defined as a "swap agreement" (as defined in section 206A of the GLBA[301]) of which "a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, including any interest therein" but does not include a security-based swap.[302] The Dodd-Frank Act amended the definition of "swap agreement" in section 206A of the GLBA[303] to eliminate the

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300 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78); CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v). The Dodd-Frank Act provides that certain CFTC registrants, such as DCOs and SEFs, will keep records regarding SBSAs open to inspection and examination by the SEC upon request. See, e.g., sections 725(e) and 733 of the Dodd-Frank Act. The Commissions are committed to working cooperatively together regarding their dual enforcement authority over SBSAs.

301 15 U.S.C. 78c note.

302 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78). The CFMA amended the Exchange Act and the Securities Act to exclude swap agreements from the definitions of security in those Acts but subjected "security-based swap agreements," as defined in section 206B of the GLBA, 15 U.S.C. 78c note, to the antifraud, anti-manipulation, and anti-insider trading provisions of the Exchange Act and Securities Act. See CFMA, supra note 182, tit. III.

The CEA does not contain a stand-alone definition of "security-based swap agreement" but includes the definition instead in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (see section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), while the definition of SBSA in the CEA does not contain a similar exclusion. Instead, the exclusion for security-based swaps is placed in the general exclusions from the definition of swap in the CEA (see CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)).

303 15 U.S.C. 78c note.

requirements that a swap agreement be between ECPs, as defined in 1a(12)(C) of the CEA,[304] and subject to individual negotiation.[305]

B. Swaps that are Security-Based Swap Agreements.

Although the Commissions believe it is not possible to provide a bright line test to define an SBSA, the Commissions believe that it is possible to clarify that certain types of swaps clearly fall within the definition of SBSA. For example, a swap based on an index of securities that is not a narrow-based security index (i.e., a broad-based security index) would fall within the definition of an SBSA under the Dodd-Frank Act.[306] Similarly, an index CDS that is not based on a narrow-based security index or on the "issuers of securities in a narrow-based security index," as defined in proposed rule 1.3(zzz) under the CEA and proposed rule 3a68-1a under the Exchange Act, would be an SBSA. In addition, a swap based on a U.S. Treasury security or on certain other exempted securities other than municipal securities would fall within the definition of an SBSA under the Dodd-Frank Act.[307] The Commissions have received no comments

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304 7 U.S.C. 1a(12)(C).

305 See section 762(b) of the Dodd-Frank Act. Sections 762(c) and (d) of the Dodd-Frank Act also made conforming amendments to the Exchange Act and the Securities Act to reflect the changes to the regulation of "swap agreements" that are either "security-based swaps" or "security-based swap agreements" under the Dodd-Frank Act.

306 Swaps based on indexes that are not narrow-based security indexes are not included within the definition of the term security-based swap under the Dodd-Frank Act. See section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I), and discussion supra part III.G. However, such swaps have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore such swaps fall within the SBSA definition.

307 Swaps on U.S. Treasury securities that do not have any other underlying references involving securities are expressly excluded from the definition of the term "security-based swap" under the Dodd-Frank Act. See section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that an agreement, contract, or transaction that would be a security-based swap solely because it references, is based on, or settles through the delivery of one or more U.S. Treasury securities (or certain other exempted securities) is

regarding the definition of SBSA in the Dodd-Frank Act in response to the ANPR, and have not been made aware of any significant market confusion regarding what constitutes an SBSA since the definition of SBSA was enacted as part of the CFMA in 2000. Accordingly, the Commissions are not proposing to further define SBSA at this time beyond providing the examples above.[308]

Request for Comment:

132. The Commissions request comment on whether further clarification of the definition of SBSA is necessary or appropriate. Commenters should provide a detailed analysis regarding what further guidance should be provided and how that guidance would affect what constitutes an SBSA.

133. The Commissions also request comment on whether there are other examples of swap transactions that the Commissions should clarify meet the definition of SBSA.

C. Books and Records Requirements for Security-Based Swap Agreements.

The Dodd-Frank Act requires the Commissions to adopt rules regarding the books and records required to be kept for SBSAs. Specifically, section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly

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excluded from the security-based swap definition). However, swaps on U.S. Treasury securities or on other exempted securities covered by subparagraph (C) of the security-based swap definition have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore they fall within the SBSA definition.

308 The Commissions note that certain transactions that were not "security-based swap agreements" under the CFMA are nevertheless included in the definition of security-based swap under the Dodd-Frank Act – including, for example, a CDS on a single loan. Accordingly, although such transactions were not subject to insider trading restrictions under the CFMA, under the Dodd-Frank Act they are subject to the federal securities laws, including insider trading restrictions.

adopt rules governing books and records requirements for SBSAs by persons registered as SDRs under the CEA, including uniform rules that specify the data elements that shall be collected and maintained by each SDR. Similarly, section 712(d)(2)(C) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading records, for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.

As discussed above, SBSAs are swaps over which the CFTC has primary regulatory authority, but for which the SEC has antifraud, anti-manipulation, and certain other authority. The CFTC has proposed rules governing books and records for swaps, which would apply to swaps that also are SBSAs.[309] The Commissions believe that the proposed rules would provide sufficient books and records regarding SBSAs and do not believe that additional books and records requirements are necessary for SBSAs. The Commissions therefore are proposing rules to clarify that there would not be additional books and records requirements regarding SBSAs other than those proposed for swaps. Specifically, proposed rule 1.7 under the CEA and proposed rule 3a69-3 under the Exchange Act would not require persons registered as SDRs under the CEA and the rules and regulations thereunder to i) keep and maintain additional books and records regarding SBSAs other than the books and records regarding swaps that SDRs would be required to

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309 See Swap Data Recordkeeping and Reporting Requirements, supra note 6 (proposed rules regarding swap data recordkeeping and reporting requirements for SDRs, DCOs, DCMs, SEFs, swap dealers, major swap participants, and swap counterparties who are neither swap dealers nor major swap participants); Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, supra note 7 (proposed rules regarding reporting and recordkeeping requirements and daily trading records requirements for swap dealers and major swap participants).

keep and maintain pursuant to the CEA and rules and regulations thereunder; and ii) collect and maintain additional data regarding SBSAs other than the data regarding swaps that SDRs would be required to collect and maintain pursuant to the CEA and rules and regulations thereunder.

In addition, the proposed rules would not require persons registered as swap dealers or major swap participants under the CEA and rules and regulations thereunder, or registered as security-based swap dealers or major security-based swap participants under the Exchange Act and rules and regulations thereunder, to keep and maintain additional books and records, including daily trading records, regarding SBSAs other than the books and records regarding swaps those persons would be required to keep and maintain pursuant to the CEA and the rules and regulations thereunder.[310]

Request for Comment:

134. The Commissions request comment on the proposed rules regarding books and records requirements for SBSAs. Will requiring the same recordkeeping information for SBSAs that will be required for swaps under the CFTC's recordkeeping rules be sufficient? Should the Commissions impose additional recordkeeping requirements for SBSAs? If so, why, and what additional recordkeeping should be required?

VI. Process for Requesting Interpretations of the Characterization of a Title VII Instrument.

As discussed above, there may be Title VII instruments (or classes of Title VII instruments) that may be difficult to categorize definitively as swaps or security-based

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[310] Proposed rule 1.7 under the CEA and proposed rule 3a69-3 under the Exchange Act would provide that the term "security-based swap agreement" has the meaning set forth in CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v), and section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), respectively.

swaps. Further, because mixed swaps are both swaps and security-based swaps, identifying a mixed swap may not always be straightforward.

Section 712(d)(4) of the Dodd-Frank Act provides that any interpretation of, or guidance by, either the CFTC or SEC regarding a provision of Title VII shall be effective only if issued jointly by the Commissions (after consultation with the Board) on issues where Title VII requires the CFTC and SEC to issue joint regulations to implement the provision. The Commissions believe that any interpretation or guidance regarding whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), must be issued jointly pursuant to this requirement. Consequently, the Commissions are proposing a process for interested persons to request a joint interpretation by the Commissions regarding whether a particular Title VII instrument (or class of Title VII instruments) is a swap, a security-based swap, or both (i.e., a mixed swap).

Section 718 of the Dodd-Frank Act establishes a process for determining the status of "novel derivative products" that may have elements of both securities and futures contracts. section 718 of the Dodd-Frank Act provides a useful model for a joint Commission review process to appropriately categorize Title VII instruments. As a result, the Commissions' proposed process rules regarding swaps, security-based swaps, and mixed swaps include various attributes of the process established in section 718 of the Dodd-Frank Act. In particular, to permit an appropriate review period that provides sufficient time to ensure federal regulatory interests are satisfied that also does not unduly delay the introduction of new financial products, the proposed process, like the process established in section 718, would include a deadline for responding to a request for a joint interpretation.[311]

Proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act would establish a process for parties to request a joint interpretation regarding the characterization of a particular Title VII instrument (or class thereof). Specifically, paragraph (a) of the proposed rules would provide that any person may submit a request to the Commissions to provide a public joint interpretation of whether a particular Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap).

Paragraph (a) of the proposed rules is intended to afford market participants with the opportunity to obtain greater certainty from the Commissions regarding the regulatory status of particular Title VII instruments under the Dodd-Frank Act. This provision should decrease the possibility that market participants inadvertently might violate the regulatory requirements applicable to a particular Title VII instrument.

Paragraph (b) of proposed rules 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act would provide that a person requesting an interpretation as to the characterization of a Title VII instrument as a swap, a security-based swap, or both (i.e., a mixed swap), must provide the Commissions with the person's determination of the characterization of the instrument and supporting analysis, along with certain other documentation. Specifically, the person must provide the Commissions with the following information:

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311 The Commissions note that section 718 of the Dodd-Frank Act is a separate process from the process the Commissions are proposing, and that any future interpretation involving the process under section 718 would not affect the process being proposed here, nor would any future interpretation involving the process proposed here affect the process under section 718.

- All material information regarding the terms of the Title VII instrument;
- A statement of the economic characteristics and purpose of the Title VII instrument;
- The requesting person's determination as to whether the Title VII instrument should be characterized as a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such determination; and
- Such other information as may be requested by either Commission.

This provision is intended to provide the Commissions with sufficient information regarding the Title VII instrument at issue so that the Commissions can appropriately evaluate whether it is a swap, a security-based swap, or both (i.e., a mixed swap). By requiring that requesting persons furnish a determination regarding whether they believe the Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such determination, this provision also would assist the Commissions in more quickly identifying and addressing the relevant issues involved in arriving at a joint interpretation of the characterization of the instrument.

Paragraph (c) of proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act would provide that a person may withdraw a request made pursuant to paragraph (a) at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commissions. Notwithstanding any such withdrawal, the Commissions may provide an interpretation regarding the characterization of the Title VII instrument that was the subject of a withdrawn request.

This provision is intended to permit parties to withdraw requests for which the party no longer needs an interpretation. This, in turn, would save the Commissions time and staff resources. If the Commissions believe such an interpretation is necessary regardless of a particular request for interpretation, however, the Commissions may provide such a joint interpretation of their own accord.

Paragraph (d) of proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act would provide that if either Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (i.e., a mixed swap), the receiving Commission promptly shall notify the other. This provision of the proposed rules would further provide that either Commission, or their Chairmen jointly, may submit a request for a joint interpretation as to the characterization of the Title VII instrument where no external request has been received.

This provision is intended to ensure that Title VII instruments do not fall into regulatory gaps and will help the Commissions to fulfill their responsibility to oversee the regulatory regime established by Title VII of the Dodd-Frank Act by making sure that Title VII instruments are appropriately characterized, and thus appropriately regulated. An agency, or their Chairmen jointly, submitting a request for an interpretation as to the characterization of a Title VII instrument under this paragraph would be required to submit the same information as, and could withdraw a request in the same manner as, a person submitting a request to the Commissions. The bases for these provisions are set forth above with respect to paragraphs (b) and (c) of these proposed rules.

Paragraph (e) of proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act would require the Commissions, if they determine to issue a joint interpretation as to the characterization of a Title VII instrument, to do so within 120 days of receipt of the complete external or agency submission (unless such 120-day period is tolled during the pendency of a request for public comment on the proposed interpretation).[312] If the Commissions do not issue a joint interpretation within the prescribed time period, the proposed rules require that each Commission publicly provide the reasons for not having done so. This provision of the proposed rules also incorporates the mandate of the Dodd-Frank Act that any joint interpretation by the Commissions be issued only after consultation with the Board of Governors of the Federal Reserve System.[313] Finally, paragraph (e) makes clear that nothing in the proposed rules requires either Commission to issue a requested joint interpretation regarding the characterization of a particular instrument.

These provisions are intended to guarantee market participants a prompt review of submissions requesting a joint interpretation of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap). The proposed rules also would provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested interpretation or publicly state the reasons for not doing so.

Paragraph (f) of proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act would permit the Commissions, in lieu of issuing a requested interpretation, to issue (within the timeframe for issuing a joint interpretation) a joint notice of proposed rulemaking to further define one or more of the terms "swap,"

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312 This 120-day period is based on the timeframe set forth in section 718(a)(3) of the Dodd-Frank Act.

313 See section 712(d)(4) of the Dodd-Frank Act.

"security-based swap," or "mixed swap." Such a rulemaking, as required by Title VII, would be required to be done in consultation with the Board of Governors of the Federal Reserve System. This paragraph is intended to provide the Commissions with needed flexibility to address issues that may be of broader applicability than the particular Title VII instrument that is the subject of a request for a joint interpretation.

Request for Comment:

135. The Commissions request comment generally on all aspects of proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act.

136. Should proposed rule 1.8(a) under the CEA and proposed rule 3a68-2(a) under the Exchange Act include a more specific process for persons to request a joint interpretation of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap)? If so, what additional specificity would be appropriate?

137. Would the information required by paragraph (b) of the proposed rules be sufficient for the Commissions to consider a request? Should requesting persons have to provide a statement regarding the economic characteristics and purpose of the Title VII instrument? Should requesting persons have to provide a determination regarding whether such instrument should be characterized as a swap, a security-based swap, or both (i.e., a mixed swap), along with reasons therefor?

138. Is there additional or alternative information that the Commissions should require persons to submit in connection with a request for an interpretation regarding whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap)? If so, what additional or alternative information should be required?

139. Should persons be able to withdraw a request for an interpretation pursuant to paragraph (c) of proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act? Why or why not? Should there be additional parameters around or requirements regarding such withdrawals? If so, what should they be?

140. Is the 120-day timeframe for issuance of a requested joint interpretation provided for in paragraph (e) of proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act appropriate? Is it too short or too long? Are the provisions for tolling this timeframe during a public comment period, and for permitting the Commissions to proceed with a joint notice of proposed rulemaking instead of issuing a joint interpretation, appropriate? Why or why not? Where the Commissions do not issue a joint interpretation, is it helpful that they each publicly provide the reasons for not doing so within the applicable timeframe? Why or why not?

141. Title VII requires that certain persons that are registered with the CFTC keep books and records relating to SBSAs open to inspection and examination by the SEC. As discussed in part V above, the Commissions are not proposing additional recordkeeping or other regulatory requirements for SBSAs that would require pre-transaction identification of a swap as an SBSA by market participants. Under these circumstances, is it appropriate to include SBSAs in the interpretation process set forth in proposed rule 1.8 under the CEA and proposed rule 3a68-2 under the Exchange Act? Why or why not?

142. Would it be appropriate to include SBSAs in the interpretation process, if their inclusion required the Commissions to extend the 120-day timeframe for issuance of

a requested joint interpretation to, for example, 180 days for all products in order to address a potential increase in requests? Why or why not?

VII. Anti-Evasion.

A. CFTC Proposed Anti-Evasion Rules.

Section 721(c) of the Dodd-Frank Act requires the CFTC to adopt a rule to further define the terms "swap," "swap dealer," "major swap participant," and "eligible contract participant," in order "[t]o include transactions and entities that have been structured to evade" subtitle A of Title VII (or an amendment made by subtitle A). Section 761(b)(3) of the Dodd-Frank Act, in turn, grants discretionary authority to the SEC to define the terms "security-based swap," "security-based swap dealer," "security-based major swap participant," and "eligible contract participant," with regard to security-based swaps, "for the purpose of including transactions and entities that have been structured to evade subtitle B of Title VII (or amendments made by subtitle B). The CFTC notes that several provisions of Title VII reference the promulgation of anti-evasion rules:

- subparagraph (E) of the definition of "swap" provides that foreign exchange swaps and foreign exchange forwards shall be considered swaps unless the Secretary of the Treasury makes a written determination that either foreign exchange swaps or foreign exchange forwards, or both, among other things, "are not structured to evade the [Dodd-Frank Act] in violation of any rule promulgated by the [CFTC] pursuant to section 721(c) of that Act;"[314]

- section 722(d) of the Dodd-Frank Act provides that the provisions of the CEA relating to swaps shall not apply to activities outside the United States unless those

[314] CEA section 1a(47)(E), 7 U.S.C. 1a(47)(E).

activities, among other things, "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by the [Title VII];"[315] and

- section 725(g) of the Dodd-Frank Act amends the Legal Certainty for Bank Products Act of 2000 to provide that, although identified banking products generally are excluded from the CEA, that exclusion shall not apply to an identified banking product that is a product of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency,[316] meets the definition of "swap" or "security-based swap," and "has been structured as an identified banking product for the purpose of evading the provisions of the [CEA], the [Securities Act], or the [Exchange Act]."[317]

The CFTC has determined to exercise its anti-evasion rulemaking authority under the Dodd-Frank Act.[318]

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315 CEA section 2(i), 7 U.S.C. 2(i). New CEA section 2(i), as added by section 722(d) of the Dodd-Frank Act, also provides that the provisions of Title VII relating to swaps shall not apply to activities outside the United State unless those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States."

316 The term "identified banking product" is defined in section 402 of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27. The term "appropriate Federal banking agency" is defined in CEA section 1a(2), 7 U.S.C. 1a(2), and section 3(a)(72) of the Exchange Act, 15 U.S.C. 78c(a)(72), which were added by sections 721(a) and 761(a) of the Dodd-Frank Act, respectively.

317 Section 741(b) of the Dodd-Frank Act amends section 6(e) of the CEA, 7 U.S.C. 9a, to provide that any DCO, swap dealer, or major swap participant "that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) [of the CEA] shall be liable for a civil monetary penalty in twice the amount otherwise available for a violation of section 2(h) [of the CEA]." This anti-evasion provision is not dependent upon the promulgation of a rule under section 721(c) of the Dodd-Frank Act, and hence this release does not apply to the anti-evasion authority regarding CEA section 2(h), 7 U.S.C. 2(h).

318 No comments were received in response to the ANPR that specifically addressed anti-evasion authority. One commenter, however, noted that evasion is a concern. See Letter from David A. Berg, Esq., Vice President & General Counsel, Air Transport Association (Sept. 20, 1010).

Structuring transactions and entities to evade the requirements of the Dodd-Frank Act could take any number of forms. As with the law of manipulation, the "methods and techniques" of evasion are "limited only by the ingenuity of man."[319] In light of the myriad methods of potential evasion, any attempt to comprehensively determine what constitutes evasion, or to provide a bright-line test of evasion by rule, would likely not be effective as would-be evaders could simply restructure their transactions or entities to fall outside any rigid boundary. Accordingly, proposed rule 1.3(xxx)(6) under the CEA generally would define as swaps those transactions that are willfully structured to evade the provisions of Title VII governing the regulation of swaps. Specific provisions would apply in similar fashion to currency and interest rate swaps that are willfully structured as foreign exchange forwards or foreign exchange swaps, and to transactions of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency where the transactions are willfully structured as identified banking products to evade the new regulatory regime for swaps that was enacted in Title VII. These proposed rules would not apply to any agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Exchange Act).

The Dodd-Frank Act also gives the CFTC general authority to prevent evasion of Title VII that occurs outside of the United States. Specifically, as noted above, section 722(d) of the Dodd-Frank Act states that the provisions of the CEA relating to swaps that were enacted by Title VII (including any rule prescribed or regulation promulgated thereunder) shall not apply to activities outside the United States unless, among other

319 Cargill v. Hardin, 452 F.2d 1154, 1163 (8th Cir. 1971).

things, those activities "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by [Title VII]." The CFTC is proposing rules to address potential evasion of Title VII under this provision of the Dodd-Frank Act.

Proposed rule 1.6 under the CEA would prohibit activities conducted outside the United States, including entering into transactions and structuring entities, to willfully evade or attempt to evade any provision of the CEA as enacted under Title VII or the rules and regulations promulgated thereunder. No activity, however, conducted outside of the United States with respect to a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Exchange Act) and that is subject to the jurisdiction of the SEC would be prohibited pursuant to proposed rule 1.6.

The CFTC's proposed rule 1.3(xxx)(6) further defining the term "swap" would further provide that transactions, other than transactions structured as securities, willfully structured to evade shall be considered in determining whether a person is a swap dealer or major swap participant. Proposed rule 1.6 would further provide that an activity conducted outside the United States, other than an activity with respect to a security (including a security-based swap), to willfully evade or attempt to evade, shall be subject to the swap provisions of the CEA enacted under Title VII of the Dodd-Frank Act. The CFTC believes that these provisions are necessary to fully prevent those who seek to willfully evade the regulatory requirements established by Congress in Title VII relating to swaps from enjoying any benefits from their efforts to evade.

Finally, the CFTC's proposed rules would provide that in determining whether a transaction has been willfully structured to evade, neither the form, label, nor written documentation of the transaction shall be dispositive. The CFTC believes that looking beyond the form of the transaction to examine its actual substance is necessary to prevent evasion through clever draftsmanship. Such an approach is consistent with the CFTC's case law in the context of determining whether a contract is a futures contract.[320]

In order to provide clarity concerning the anti-evasion rules, the CFTC also proposes to provide interpretive guidance as to certain types of circumstances that may constitute an evasion of the requirements of Title VII, while at the same time preserving the CFTC's ability to determine, on a case-by-case basis, that particular or other types of transactions or actions constitute an evasion of the requirements of the statute or the regulations promulgate thereunder. In developing this guidance, the CFTC has considered legislative, administrative, and judicial precedent with respect to the anti-evasion provisions in other federal statutes. For example, the CFTC has examined the anti-evasion provisions in the Truth in Lending Act,[321] the Bank Secrecy Act,[322] and the

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320 See, e.g., Grain Land, supra note 61, at 55748 (holding that contract substance is entitled to at least as much weight as form); First Nat'l Monetary Corp., supra note 152, at 30974; Stovall, supra note 152, at 23779 (holding that the CFTC "will not hesitate to look behind whatever label the parties may give to the instrument").

321 15 U.S.C. 1604(a) provides, in relevant part, that the Federal Reserve Board:

> shall prescribe regulations to carry out the purposes of this subchapter . . . . [T]hese regulations may contain such classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

In affirming the Board's promulgation of Regulation Z, the Supreme Court noted that anti-evasion provisions such as section 1604(a) evince Congress's intent to "stress[] the agency's power to counteract attempts to evade the purposes of a statute." Mourning v. Family Publ'ns Serv., Inc., 411 U.S. 356, 370 (1973) (citing Gemsco v. Walling, 324 U.S. 244 (1945) (giving great deference to a regulation promulgated under similar prevention-of-evasion rulemaking authority in the Fair Labor Standards Act)).

Internal Revenue Code.[323] Based on these other statutory anti-evasion provisions, as well as the CFTC's authority under the Dodd-Frank Act to define terms and promulgate rules and regulations to prevent evasion, the CFTC is proposing this interpretive guidance as to what may constitute evasion of the requirements of the Dodd-Frank Act with respect to swaps. The CFTC emphasizes, however, that it would examine each individual case on a case-by-case basis, and additional practices or circumstances may warrant a finding that particular conduct or transactions constitute an evasion of the requirements of the Dodd-Frank Act with respect to swaps.

Business Purpose. The CFTC recognizes that transactions may be structured, and entities may be formed, in particular ways for legitimate business purposes, without any intention of circumventing the requirements of the Dodd-Frank Act with respect to swaps. In evaluating whether a person is evading or attempting to evade the requirements with respect to a particular instrument, entity, or transaction, the CFTC would consider the extent to which a person has a legitimate business purpose for structuring the instrument or entity or entering into the transaction in that particular manner. Although different means of structuring a transaction or entity may have differing regulatory implications and attendant requirements, absent other indicia of

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322 31 U.S.C. 5324 (stating, in pertinent part, that "[n]o person shall, for the purpose of evading the reporting requirements of [the Bank Secrecy Act (BSA) or any regulation prescribed thereunder]. . . . structure or assist in structuring, or attempt to structure or assist in structuring, any transaction with one or more domestic financial institutions"). The Federal Deposit Insurance Corporation regulations implementing the BSA require banks to report transactions that ""the bank knows, suspects, or has reason to suspect" are "designed to evade any regulations promulgated under the Bank Secrecy Act." 12 CFR 353.3 (2010).

323 The Internal Revenue Code makes it unlawful for any person willfully to attempt "in any manner to evade or defeat any tax . . . ." 26 U.S.C. 7201. While a considerable body of case law has developed under the tax evasion provision, the statute itself does not define the term, but generally prohibits willful attempts to evade tax.

evasion, the CFTC would not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose to constitute evasion. However, to the extent a purpose in structuring an entity or instrument or entering into a transaction is to evade the requirements of Title VII with respect to swaps, the structuring of such instrument, entity, or transaction may be found to constitute evasion.[324]

Fraud, deceit, or unlawful activity. The CFTC believes that the Internal Revenue Service's delineation of what constitutes tax evasion, as elaborated upon by the courts, provides a useful guidepost for determining which types of activities should be considered to constitute an evasion of the Dodd-Frank Act. The Internal Revenue Service distinguished between tax evasion and legitimate means for citizens to minimize, reduce, avoid or alleviate the tax that they pay under the Internal Revenue Code. Whereas permissible means of reducing tax (or "tax avoidance," as the Internal Revenue Service refers to the practice) is associated with full disclosure and explanation of why the tax should be reduced under law, tax evasion consists of the willful attempt to evade tax liability, and generally involves "deceit, subterfuge, camouflage, concealment, or some attempt to color or obscure events or to make things seem other than they are."[325]

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324 A similar concept applies with respect to tax evasion. A transaction that is structured to avoid the payment of taxes but that lacks a valid business purpose may be found to constitute tax evasion. See, e.g., Gregory v. Helvering, 293 U.S. 465, 469 (1935) (favorable tax treatment disallowed because transaction lacked any business or corporate purpose). Under the "sham-transaction" doctrine, "a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose." Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001) (citing Knetsch v. United States, 364 U.S. 361 (1960)). "The doctrine has few bright lines, but 'it is clear that transactions whose sole function is to produce tax deductions are substantive shams.'" Id. (quoting United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir 2001)).

325 The Internal Revenue Service explains:

Similarly, persons that craft derivative transactions, structure entities, or conduct themselves in a deceptive or other illegitimate manner in order to avoid regulatory requirements should not be permitted to enjoy the fruits of their deceptive or illegitimate conduct. In determining whether particular conduct is an evasion of the Dodd-Frank Act, the CFTC will consider the extent to which the conduct involves deceit, deception, or other unlawful or illegitimate activity.[326]

Request for Comment:

The CFTC requests comment on all aspects of the proposed anti-evasion rules, including the following:

143. Are the CFTC's proposed rules and interpretive guidance set forth in this section sufficient to address the evasion concerns in Title VII? Is further guidance necessary? If so, what further guidance would be appropriate?

144. Is further definition of the term "swap" necessary to address transactions that have been structured to evade subtitle A of Title VII? If so, what further definition is

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> Avoidance of taxes is not a criminal offense. Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. The distinction between avoidance and evasion is fine, yet definite. One who avoids tax does not conceal or misrepresent. He/she shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events or to make things seem other than they are. For example, the creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. However, the facts of a particular investigation may show that an alleged partnership was not, in fact, established and that one or more of the alleged partners secretly returned his/her share of the profits to the real owner of the business, who, in turn, did not report this income. This would be an instance of attempted evasion.

Internal Revenue Service, Internal Revenue Manual, part 9.1.3.3.2.1, available at http://www.irs.gov/irm/part9/irm_09-001-003.html#d0e169.

326 Although deceitful, deceptive, or illegitimate conduct may be sufficient to find that evasion has occurred, such conduct is not a prerequisite for a finding of evasion, particularly when other indicia of evasion are present, such as, for example, when the transaction lacks any business purpose.

appropriate, and why? Please provide specific examples or scenarios, and a detailed analysis of any such transactions and the guidance that would be appropriate.

145. In addition to defining the term "swap" to address evasion generally, and with respect to certain foreign exchange products and identified banking products in particular, are CFTC rules prohibiting transactions from being willfully structured to evade or attempt to evade (similar to the proposed rules regarding activities conducted outside the United States) subtitle A of Title VII appropriate?

B. SEC Request for Comment Regarding Anti-Evasion.

Section 761(b)(3) of the Dodd-Frank Act grants discretionary authority to the SEC to define the terms "security-based swap," "security-based swap dealer," "security-based major swap participant," and "eligible contract participant," with regard to security-based swaps, "for the purpose of including transactions and entities that have been structured to evade subtitle B of Title VII (or amendments made by subtitle B). Section 772(b) of the Dodd-Frank Act states that the provisions of the Exchange Act that were added by Title VII (including any rule or regulation thereunder) shall not apply to any person insofar as that person transacts a business in security-based swaps outside the jurisdiction of the United States, unless such person transacts such business "in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent evasion of any provision of [the Exchange Act] that was added by [Title VII]."[327]

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[327] See section 30(c) of the Exchange Act, 15 U.S.C. 78dd(c).

The SEC is not proposing specific rules regarding anti-evasion at this time. The SEC may consider whether to propose anti-evasion rules based on comments received or after having experience with the new regulatory regime under subtitle B of Title VII.

Request for Comment:

146. The SEC requests comment on whether SEC rules or interpretive guidance addressing anti-evasion regarding security-based swaps, security-based swap dealers, major security-based swap participants, or ECPs are necessary. Why or why not? Should the SEC adopt rules and interpretive guidance modeled on the CFTC's proposals? If other rules or interpretive guidance are necessary, please provide a detailed description of what rules or interpretative guidance would be necessary.

147. Are SEC rules or interpretive guidance addressing evasion in the context of activities conducted outside the United States necessary? Why or why not? Should the SEC adopt rules and interpretive guidance modeled on the CFTC's proposals? If other rules or interpretive guidance are necessary, please provide a detailed description of what rules or interpretative guidance would be necessary.

VIII. Administrative Law Matters – CEA Revisions.

A. Regulatory Flexibility Act.

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[328] Most of the entities that will be impacted by this proposed rulemaking have previously been determined to not be small entities. In addition, this proposed rulemaking, which

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[328] 5 U.S.C. 601 et seq.

provides interpretive guidance, general rules of construction and definitions that will largely be used in other rulemakings will, by itself, not impose a significant economic impact on market participants or entities.

1. Effect of the Proposed Rulemaking.

The proposed rulemaking in this release further defines, and clarifies, the statutory terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap." It also provides a process for requesting joint interpretations from the Commissions as to whether agreements, contracts, and transactions are swaps, security-based swaps, or mixed swaps, as well as a process for requesting alternative regulatory treatment for certain mixed swaps. This proposed rulemaking also includes books and records, and data, requirements for SDRs, swap dealers, and major swap participants with respect to SBSAs, and implements the anti-evasion rulemaking authority granted to the CFTC under several provisions of the Dodd-Frank Act.

Additionally, this release proposes interpretive guidance that the forward contract exclusion from the swap definition in the Dodd-Frank Act with respect to nonfinancial commodities should be read consistently with the forward contract exclusion from the CEA definition of the term "future delivery." In that regard, the CFTC is proposing to retain the Brent Interpretation and extend it to apply to all nonfinancial commodities, and as a result, to withdraw the Energy Exemption,[329] which had extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil. The Energy Exemption listed certain "appropriate persons" that could rely on the exemption.

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[329] Energy Exemption, supra note 72.

The CFTC anticipates that this proposed rulemaking will affect primarily the following entities: DCMs, DCOs, ECPs, swap dealers, major swap participants, SEFs, SDRs, FBOTs, and those "appropriate persons" who previously relied on the Energy Exemption.

2. Specific Entities That are Not Small Entities.

The vast majority of entities impacted by this proposed rulemaking previously have been determined to not be small entities by the CFTC. Prior to the enactment of the Dodd-Frank Act, the following entities had been determined by the CFTC to not be small entities for purposes of the RFA: DCMs, DCOs, and ECPs. Other entities that will be affected by this rulemaking, including swap dealers, major swap participants, SEFs, SDRs, and FBOTs, have been certified by the CFTC not to be small entities in other proposed recent CFTC rulemaking implementing requirements of the Dodd-Frank Act. Specifically:

i. Swap Dealers, Major Swap Participants, SEFs, SDRs, and FBOTs. The CFTC previously has certified that swap dealers, major swap participants, SEFs, SDRs, and FBOTs are not small entities for purposes of the RFA.[330] Nevertheless, because these are new categories of registrants under the Dodd-Frank Act, the CFTC is, again, hereby determining that these entities are not small entities.

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330 See respectively, Registration of Swap Dealers and Major Swap Participants, 75 FR 71379, 71385, Nov. 23, 2010 (swap dealers and major swap participants); Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 FR 63732, 63745, Oct. 18, 2010 (SEFs); Swap Data Repositories, 75 FR 80898, 80926, Dec. 23, 2010 (SDRs); Registration of Foreign Boards of Trade, 75 FR 70974, 70987, Nov. 19, 2010 (FBOTs).

a. Swap Dealers: As noted above, the CFTC previously has determined that FCMs are not small entities for the purpose of the RFA based upon, among other things, the requirements that FCMs must meet, including certain minimum financial requirements that enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally. Swap dealers similarly will be subject to minimum capital and margin requirements, and are expected to comprise the largest global financial firms. Entities that engage in a de minimis quantity of swap dealing in connection with transactions with or on behalf of customers will be exempt from designation as a swap dealer. For purposes of the RFA, the CFTC is hereby determining that swap dealers not be considered to be "small entities" for essentially the same reasons that FCMs previously have been determined not to be small entities.

b. Major Swap Participants: The CFTC also previously has determined that large traders are not small entities for the purpose of the RFA. Major swap participants, among other things, maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets. For purposes of the RFA, the CFTC is hereby determining that major swap participants not be considered to be "small entities" for essentially the same reasons that large traders previously have been determined not to be small entities.

c. SEFs: The Dodd-Frank Act defines a SEF to mean a trading system or platform in which multiple participants have the ability to accept bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between persons and is not a DCM. The CFTC previously has determined that DCMs are not small entities because, among other things, they may be designated only when they meet specific criteria, including expenditure of sufficient resources to establish and maintain adequate self-regulatory programs. Likewise, the CFTC will register an entity as a SEF only after it has met specific criteria, including the expenditure of sufficient resources to establish and maintain an adequate self-regulatory program. For purposes of the RFA, the CFTC is hereby determining that SEFs not be considered to be "small entities" for essentially the same reasons that DCMs previously have been determined to be small entities.

d. SDRs: The CFTC previously has determined that DCMs and DCOs are not small entities because, among other things, of "the central role" they play in "the regulatory scheme concerning futures trading."[331] Because of the "importance of futures trading in the national economy," to be designated as a contract market or registered as a DCO, the respective entity must meet stringent requirements set forth in the CEA. Similarly, swap positions that are recorded, reported and disseminated by SDRs will be an important part of the national economy. SDRs will receive data from market participants and will be obligated to facilitate swap execution by reporting real-time data. Similar to DCMs and DCOs, SDRs will play a central role both in the regulatory scheme concerning swap trading. Additionally, the Dodd-Frank Act permits DCOs to register as SDRs. For purposes of the RFA, the CFTC is hereby determining

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331 Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, 47 FR 18618, Apr. 30, 1982.

that SDRs not be considered to be "small entities" for essentially the same reasons that DCMs and DCOs previously have been determined not to be small entities.

e. FBOTs. The term "foreign board of trade" has been used in the CEA and in the CFTC's Regulations to refer to a board of trade "located outside the U.S."[332] The term "board of trade" is defined in the CEA as "any organized exchange or trading facility."[333] An "organized exchange," in turn, includes designated or registered exchanges, such as DCMs.[334] The CFTC previously has determined that DCMs are not "small entities." As noted above, because of DCMs' importance to the economy, they must meet stringent requirements set forth in the CEA. Similarly, the CFTC will register an FBOT only after it has met criteria similar to those required of a DCM. Critically, an FBOT will be registered only after demonstrating, among other things, that it possesses the attributes of an organized exchange, adheres to appropriate rules prohibiting abusive trading practices, and enforces appropriate rules to maintain market and financial integrity. Because FBOTs and DCMs are functionally equivalent entities, for purposes of the RFA, the CFTC hereby is determining that FBOTs not be considered to be small entities for essentially the same reasons that DCMs previously have been determined not to be small entities.

ii. DCMs, DCOs, and ECPs. The CFTC previously has determined that DCMs, DCOs, and ECPs, are not small entities for purposes of the Regulatory Flexibility

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332 See CEA section 4(a), 7 U.S.C. 6(a); CFTC rule 1.33(ss), 17 C.F.R. 1.33(ss).

333 CEA section 1a(2), 7 U.S.C. 1a(2).

334 CEA section 1a(27), 7 U.S.C. 1a(27).

Act.[335] The Dodd-Frank Act requires that counterparties to swaps that are traded on a bilateral basis not on or subject to the rules of a DCM be ECPs. Prior to the enactment of the Dodd-Frank Act, ECPs trading swaps were generally outside the scope of CFTC oversight under the CEA. The CFTC cannot estimate with precision the number of non-ECPs that will, as permitted by the Dodd-Frank Act, trade swaps on DCMs. Nevertheless, this proposed rulemaking by the CFTC provides proposed further definitions of the terms "swap," "security-based swap," "mixed swap" and "security-based swap agreement," and proposes rules of construction and interpretive guidance (including guidance as to agreements, contracts, and transactions that are not included within the scope of the swap definition), that will largely be used in other rulemakings and which, by themselves, do not impose significant new regulatory requirements on market participants.

iii. "Appropriate Persons" who relied on the Energy Exemption. The Energy Exemption listed certain "appropriate persons" that could rely on the exemption and also required that, to be eligible for this exemption, an "appropriate person" must have a demonstrable capacity or ability to make or take delivery. The Energy Exemption stated: "in light of the general nature of the current participants in the market, the CFTC believes that smaller commercial firms, which cannot meet [certain] financial criteria, should not be included."[336] Therefore, the CFTC does not believe that the "appropriate persons"

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335 See respectively, Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, supra note 331, at 18619 (DCMs); A New Regulatory Framework for Clearing Organizations, 66 FR 45604, 45609, Aug. 29, 2001 (DCOs); Opting Out of Segregation. 66 FR 20740, 20743, Apr. 25, 2001 (ECPs).

336 Energy Exemption, supra note 72.

eligible for the Energy Exemption, and who may be affected by its withdrawal, are "small entities" for purposes of RFA.

Accordingly, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant impact on a substantial number of small entities. Nonetheless, the CFTC specifically requests comment on the impact that this proposed rulemaking may have on small entities.

B. Paperwork Reduction Act.

1. Introduction.

Proposed CFTC rules 1.8 and 1.9 would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"). 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 Office of Management and Budget (OMB) control number.

2. Summary of the Proposed Requirements.

Proposed rule 1.8 of the CEA would allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class thereof) is a swap, security-based swap, or mixed swap. Proposed rule 1.8 provides that a person requesting an interpretation as to the nature of an agreement, contract, or transaction as a swap, security-based swap, or mixed swap must provide the Commissions with the person's determination of the nature of the instrument and supporting analysis, along with certain other documentation, including a statement of the economic purpose for, and a copy of all material information regarding the terms of, each relevant agreement, contract, or transaction (or class thereof). The Commissions also may request the submitting person to provide additional information. In response to the submission, the Commissions may issue a joint interpretation regarding the status of that agreement, contract, or transaction (or class of agreements, contracts, or transactions) as a swap, security-based swap, or mixed swap.

Proposed rule 1.9 enables persons to submit requests to the Commissions for joint orders providing an alternative regulatory treatment for particular mixed swaps. Under proposed rule 1.9, a person would provide to the Commissions a statement of the economic purpose for, and a copy of all material information regarding, the relevant mixed swap. In addition, the person would provide the specific alternative provisions that the person believes should apply to the mixed swap, the reasons the person believes it would be appropriate to request an alternative regulatory treatment, and an analysis of: i) the nature and purposes of the specified provisions; ii) the comparability of the specified provisions to other statutory provisions of Title VII of the Dodd-Frank Act and the rules and regulations thereunder; and iii) the extent of any conflicting or incompatible requirements of the specified provisions and other statutory provisions of Title VII and the rules and regulations thereunder. The Commissions also may request the submitting person to provide additional information.

3. Information Provided by Reporting Entities.

The burdens imposed by proposed CFTC rules 1.8 and 1.9 are the same as the burdens imposed by the SEC's proposed rules 3a68-2 and 3a68-4. Therefore, the burdens that would be imposed on market participants under CFTC rules 1.8 and 1.9 already have been accounted for within the SEC's calculations regarding the impact of this collection of information under the PRA and the request for a control number that will be submitted by the SEC to OMB.[337]

4. Information Collection Comments.

The CFTC invites public comment on any aspect of the reporting and recordkeeping burdens discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the CFTC solicits comments in order to: i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the CFTC, including whether the information will have practical utility; ii) evaluate the accuracy of the CFTC's estimate of the burden of the proposed collections of information; iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and iv) 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.

Comments may be submitted directly to the OMB's Office of Information and Regulatory Affairs, by fax at (202) 395–6566 or by e-mail at OIRAsubmissions@omb.eop.gov. Please provide the CFTC with a copy of submitted comments so that all comments can be summarized and addressed in the preamble to the final rulemaking. Please refer to the Addresses section of this notice of proposed rulemaking for comment submission instructions to the CFTC. A copy of the supporting statements for the collections of information discussed above may be obtained by visiting RegInfo.gov. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release in the Federal

[337] 44 U.S.C. 3501-3521. See also 44 U.S.C. 3509 and 3510.

Register. Consequently, a comment to OMB is most ensured of being fully effective if received by OMB (and the CFTC) within 30 days after publication of this release. Nothing in the foregoing affects the deadline enumerated above for public comment to the CFTC on the rules and interpretive guidance proposed herein.

C. Cost-Benefit Analysis.

CEA section 15(a)[338] requires the CFTC to consider the costs and benefits of its actions before issuing a rulemaking under the CEA. By its terms, section 15(a) does not require the CFTC to quantify the costs and benefits of a rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the CFTC "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: i) protection of market participants and the public; ii) efficiency, competitiveness, and financial integrity of futures markets; iii) price discovery; iv) sound risk management practices; and v) other public interest considerations. The CFTC may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the CEA.

1. Costs and Benefits of the Proposed Definitions.

The proposed rulemaking and interpretive guidance would further define the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap." The scope of the definitions of the terms "swap," "security-based swap,"

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338 7 U.S.C. 19(a).

"security-based swap agreement," and "mixed swap" will be an important factor in determining the scope of activities and entities that will be subject to various requirements set forth in the Dodd-Frank Act, such as reporting, registration, business conduct, and capital requirements. Those requirements, which will be implemented in rules proposed or to be proposed by the CFTC, will likely lead to compliance costs, capital holding costs, and other costs, which have been or will be addressed in the CFTC's proposals to implement those requirements.

Yet, the CFTC believes that the proposal to further define the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap" is, for the most part, in line with the expectations of market participants and does not depart significantly from how market participants would interpret the statutory definitions of these terms set forth in Title VII of the Dodd-Frank Act. Thus, the CFTC does not believe that the proposed rules and interpretive guidance further defining these terms impose any significant incremental costs beyond the costs associated with the statutory definitions.

The CFTC also believes that the proposed rules and guidance regarding the definitions will lead to benefits in the form of increased market transparency, reduced systemic risk, and a lower incidence of market-wide crises and other market failures. Further, the proposed rules and guidance can be consistently applied by substantially all market participants to determine which agreements, contracts, or transactions are, and which are not, swaps, security-based swaps, security-based swap agreements, or mixed swaps. Thus, the proposed rules and interpretive guidance will help to create a level playing field. Market participants will be able to use Title VII instruments more efficiently and the swap markets will operate more effectively because all market participants will be relying on consistent and clear definitions. The clarity provided by the proposed rules and interpretive guidance relating to the definitions is in the public interest because this clarity will permit the public to better evaluate information about Title VII instruments made available under the Dodd-Frank Act. In particular, they will allow market participants to better understand publicly-available price data. The clarity of the definitions also has the potential to ease the negotiation of Title VII instruments and reduce other transaction costs. These factors are expected to permit the public to make a more extensive use of Title VII instruments for risk management and other purposes.

The CFTC requests comment as to the costs and benefits of the proposed rules and interpretive guidance regarding the definitions for market participants, markets, and the public. In particular, comment is requested as to whether there are any aspects of the proposed rules and interpretive guidance regarding the definitions that are both burdensome to apply and not helpful to achieving clarity as to the scope of the defined terms. In addition, are there less burdensome means of providing clarity as to the scope of the defined terms?

2. Costs and Benefits of Proposed Rules and Interpretive Guidance Regarding Insurance.

Proposed CFTC rule 1.3(xxx)(4) under the CEA would clarify that insurance products that meet certain requirements, that are provided by state or federally regulated insurance companies, and that are regulated as insurance products, would not be swaps. Specifically, proposed rule 1.3(xxx)(4) would define the term "swap" so that it would not include an agreement, contract, or transaction that, by its terms or by law, as a condition of performance on the agreement, contract, or transaction: i) requires the beneficiary to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; ii) requires that loss to occur and to be proved, and that any payment or indemnification therefore be limited to the value of the insurable interest, separately from the insured interest; iii) is not traded, separately from the insured interest, on an organized market or over-the-counter; and iv) with respect to financial guarantee insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.

Proposed rule 1.3(xxx)(4) also would require that the agreement, contract, or transaction: i) be provided by a person or entity that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner, or similar official or agency, of a state (as defined under section 3(a)(16) of the Exchange Act[339]) or by the United States or an agency or instrumentality thereof, and be regulated as insurance under the laws of such state or the United States; ii) be provided by the United States or any of its agents or instrumentalities, or pursuant to a statutorily authorized program thereof; or iii) in the case of reinsurance only, be provided by a person located outside the United States to an insurance company that meets the above requirements, provided that such person is not prohibited by the law of any state or the United States from offering such agreement,

[339] 15 U.S.C. 78c(a)(16).

contract, or transaction to such insurance company, the product to be reinsured meets the requirements above for insurance products, and the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

An agreement, contract, or transaction would have to meet all of these criteria in order to qualify as an insurance product that falls outside of the swap and security-based swap definitions pursuant to the proposed rules. The Commissions also are proposing interpretative guidance to clarify that certain enumerated types of traditional insurance products, such as life insurance, health insurance, and property and casualty insurance, are outside the scope of the statutory swap and security-based swap definitions.

a) Costs.

In complying with proposed rule 1.3(xxx)(4), a market participant will need to ascertain whether an agreement, contract, or transaction is an insurance product according to the criteria set forth in the definition. This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with the proposed rule. Absent this analysis, however, the cost associated with the uncertainty cited by commenters as to whether an agreement, contract, or transaction that the participants consider to be insurance could instead be regulated as a swap is expected to be greater than the cost of the analysis proposed herein.

To the extent that the criteria under proposed rule 1.3(xxx)(4) inadvertently fail to exclude certain types of insurance products from the proposed definitions, these failures could lead to costs for market participants entering into agreements, contracts, or transactions that might be improperly regulated as swaps and not as insurance products. Similarly, to the extent that the criteria under the proposed rule lead to the inadvertent treatment of certain types of swaps as insurance, costs for market participants entering into agreements, contracts, or transactions that are improperly regulated as insurance products and not as swaps may increase.

b) Benefits.

The proposed rule and interpretative guidance regarding insurance will help to assure that traditional insurance products remain subject to the current regulatory scheme for insurance and not to the regulatory regime established by the Dodd-Frank Act for swaps. Market participants, therefore, will be able to continue to rely on their previous understanding of insurance regulations without any additional burden that may have resulted if they had to instead comply with regulations under the Dodd-Frank Act.

Without the proposed rule and interpretative guidance herein, market participants may be uncertain about whether an agreement, contract, or transaction is an insurance product that is subject to regulation as a swap. Proposed rule 1.3(xxx)(4) is intended to eliminate the potential uncertainty of what constitutes an insurance product by setting forth clear and objective criteria for determining that an agreement, contract, or transaction is an insurance product that is not subject to regulation as a swap. Providing such an objective rule and guidance alleviates additional costs of inquiring with the Commissions, or obtaining an opinion of counsel, about whether an agreement, contract, or transaction is an insurance product or a swap. The added clarity provided by the rule and guidance proposed herein will enhance the efficiency of the swaps market and also allow market participants to engage in sound risk management practices because they will be readily able to consider whether a particular agreement, contract, or transaction is insurance or a swap at the outset.

The CFTC requests comment as to the costs and benefits of proposed rule 1.3(xxx)(4) and interpretive guidance contained herein to distinguish between insurance products and swaps for market participants, markets, and the public.

3. Costs and Benefits of Proposed Rule Regarding Foreign Exchange Products and Forward Rate Agreements.

Proposed CFTC rule 1.3(xxx)(2) under the CEA would explicitly define the term "swap" to include an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, forward rate agreement, and non-deliverable forward involving foreign exchange, unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA. Proposed rule 1.3(xxx)(2) also provides that: i) a foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes the determination described in CEA section 1a(47)(E)(i); and ii) notwithstanding any such determination, certain provisions of the CEA will apply to such foreign exchange forward or foreign exchange swap (specifically, the reporting requirements in section 4r of the CEA and regulations thereunder and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA and regulations thereunder). Proposed rule 1.3(xxx)(2) further clarifies that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is not a foreign exchange forward or foreign exchange swap subject to a determination by the Secretary of the Treasury as described above.

a) Costs.

In complying with proposed rule 1.3(xxx)(2), a market participant will need to ascertain whether an agreement, contract, or transaction is a swap under the definition. This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with the proposed rule. However, any costs associated with this analysis are expected to be less than the costs of doing the same analysis absent the proposed rule, particularly given potential confusion in the event of a determination by the Secretary of the Treasury that foreign exchange forwards and/or foreign exchange swaps not be considered swaps. To the extent that proposed rule 1.3(xxx)(2) leads to the improper inclusion of certain types of agreements, contracts, and transactions in the swap definition, and therefore the imposition of additional requirements and obligations, these requirements and obligations could lead to costs for market participants entering into such agreements, contracts, or transactions.

b) Benefits.

Because the statutory definition of the term "swap" includes a process by which the Secretary of the Treasury may determine that certain agreements, contracts, and transactions that meet the statutory definition of a "foreign exchange forward" or "foreign exchange swap," respectively,[340] shall not be considered a swap, the CFTC is concerned that application of the definition, without further clarification, may cause uncertainty about whether, if the Secretary of the Treasury makes such a determination, certain agreements, contracts, or transactions would be swaps. Proposed rule 1.3(xxx)(2) would

340 CEA section 1a(24), 7 U.S.C. 1a(24)(definition of a "foreign exchange forward"); CEA section 1a(25), 7 U.S.C. 1a(25)(definition of a "foreign exchange swap").

clarify that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is a swap (unless it is otherwise excluded by the statutory definition of the term "swap"). The proposed rule also would clarify that reporting requirements, and business conduct requirements for swap dealers and major swap participants, are applicable to foreign exchange forwards and foreign exchange swaps even if the Secretary of the Treasury determines that they should not be considered swaps. The CFTC also is concerned that confusion could be generated by the "forward" label of non-deliverable forwards involving foreign exchange, and forward rate agreements. Proposed rule 1.3(xxx)(2) would clarify that these types of agreements, contracts, and transactions are swaps.

Providing a clarifying rule to market participants to determine whether certain types of agreements, contracts, or transactions are swaps alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, about whether such agreements, contracts, or transactions are swaps. In addition, a clarifying rule regarding the requirements that apply to foreign exchange forwards and foreign exchange swaps that are subject to a determination by the Secretary of the Treasury similarly alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, to determine the requirements that are applicable to such foreign exchange forwards and foreign exchange swaps. As with the other rules related to product definitions, added clarity will increase the efficiency of the swaps market and also will enable market participants to engage in sound risk management practices, which will benefit both market participants and the public.

The CFTC requests comment as to the costs and benefits of proposed rule 1.3(xxx)(2) for market participants, markets, and the public.

4. Costs and Benefits of Proposed Rules and Interpretive Guidance Regarding Title VII Instruments where the Underlying Reference is a Security Index.

Proposed CFTC rule 1.3(yyy)(1) provides that, for purposes of the security-based swap definition, the term "narrow-based security index" would have the same meaning as the statutory definition set forth in CEA section 1a(35), and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except as the new rules the Commissions are proposing provide for other treatment, market participants generally will be able to use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

The Commissions also are proposing interpretive guidance and additional rules regarding Title VII instruments based on a security index. The interpretive guidance and additional rules set forth new narrow-based security index criteria with respect to indexes composed of securities, loans, or issuers of securities referenced by an index CDS. The proposed interpretive guidance and rules also address the definition of an "index" and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated trading platforms.

a) Costs.

In complying with the proposed rules, a market participant will need to ascertain whether an index CDS is a swap or a security-based swap according to the criteria set forth in the definitions of the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" as used in the security-based swap definition. This analysis will have to be performed upon entering into an index CDS, and when the material terms of an index CDS are amended or modified, to ensure compliance with proposed rules 1.3(zzz) or 1.3(aaaa). However, any such costs are expected to be less than the costs of doing the same analysis absent the proposed rules, which the CFTC believes would be more difficult and lead to greater uncertainty. Proposed rules 1.3(zzz) and 1.3(aaaa) allow market participants to minimize the costs of determining whether an index CDS is a swap or a security-based swap by providing a test with objective criteria that is similar to a test with which they already are familiar in the security futures context, yet tailored to index CDS in particular.

Additionally, absent proposed rule 1.3(yyy), which applies the tolerance period rules, if a security index underlying a Title VII instrument traded on a trading platform migrated from being broad-based to being narrow-based, market participants may suffer disruption of their ability to offset or enter into new Title VII instruments, and incur additional costs as a result.

b) Benefits.

Proposed rules 1.3(zzz) and 1.3(aaaa) would clarify the treatment of an index CDS as either a swap or a security-based swap by setting forth objective criteria for meeting the definition of the terms "issuers of securities in a narrow-based security index" and "narrow-based security index," respectively. These objective rules will alleviate additional costs to persons trading index CDS of inquiring with the Commissions, or obtaining an opinion of counsel, to make complex determinations regarding whether an index is broad- or narrow-based, and whether an index CDS based on such an underlying index is a swap or security-based swap.

Also, proposed rules 1.3(zzz) and 1.3(aaaa) should reduce the potential for market participants to use an index CDS to evade regulations, because they set objective requirements relating to the concentration of the notional amount allocated to each reference entity or security included in the index, as well as the eligibility conditions for reference entities and securities. Finally, these proposed rules benefit the public by requiring that the providers of index CDS make publicly available sufficient information regarding the reference entities in an index underlying the index CDS. By requiring that such information be made publicly available, proposed rules 1.3(zzz) and 1.3(aaaa) seek to assure the transparency of the index components that will be beneficial to market participants who trade such instruments and to the public.

Separately, proposed rule 1.3(yyy) addresses exchange-traded swaps based on security indexes where the underlying index migrates from broad-based to narrow-based. The proposed rule includes provisions that many market participants are familiar with from security futures trading. The CFTC believes that by using a familiar regulatory scheme, market participants will be able to more readily understand the proposed rule as compared to a wholly new regulatory scheme. Also, the proposal of a "tolerance period" for swaps on security indexes that migrate from broad-based to narrow-based also creates greater clarity by establishing a 45-day timeframe (and subsequent grace period) on which market participants may rely. This tolerance period results in cost savings when compared to the alternative scenario where no tolerance period is provided and a migration of an index from broad-based to narrow-based would result in potential impediments to the ability of market participants to offset their swap positions.

Finally, the Commissions are proposing interpretive guidance that the determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made at the execution of the Title VII instrument. If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument would not change from its initial characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. Absent this guidance, market participants may need to expend additional resources to continually monitor their swaps to see if the indexes on which they are based have migrated from broad-based to narrow-based. Since the proposal provides that the initial determination prevails regardless of whether the underlying index migrates from broad-based to narrow-based, market participants do not need to expend these monitoring costs.

The CFTC requests comment as to the costs and benefits of proposed rules 1.3(yyy), 1.3(zzz), and 1.3(aaaa), and the proposed guidance contained herein, regarding Title VII instruments where the underlying reference is a security index, and regarding index CDS, for market participants, markets, and the public.

5. Costs and Benefits of Processes to Determine Whether a Title VII Instrument is a Swap, Security-Based Swap, or Mixed Swap, and to Determine Regulatory Treatment for Mixed Swaps.

a) Costs.

Proposed rule 1.8 under the CEA would allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class of agreements, contracts, or transactions) is a swap, security-based swap, or mixed swap. The CFTC estimates the cost of submitting a request for a joint interpretation pursuant to rule 1.8 would be approximately 20 hours of internal company or individual time and a cost of $9,480 for the services of outside professionals. Once such a joint interpretation is made, however, other market participants that seek to transact in the same agreement, contract, or transaction (or class thereof) would have regulatory clarity about whether it is a swap, security-based swap, or mixed swap.

Separately, proposed CFTC rule 1.9 under the CEA allows persons to submit a request for a joint order from the Commissions regarding an alternative regulatory treatment for particular mixed swaps. This process applies except with respect to bilateral, uncleared mixed swaps where one of the parties to the mixed swap is dually registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant. With respect to bilateral uncleared mixed swaps where one of the parties is a dual registrant, the proposed rule provides that such mixed swaps would be subject to a regulatory scheme set forth in rule 1.9 in order to provide clarity as to the regulatory treatment of such mixed swaps.

The CFTC estimates that the cost of submitting a request for a joint order seeking an alternative regulatory treatment for a particular mixed swap would be approximately 30 hours of internal company or individual time and a cost of approximately $15,800 for the services of outside professionals. Absent such a process, though, market participants that desire or intend to enter into such a mixed swap (or class thereof) would be required pursuant to Title VII of the Dodd-Frank Act to comply with all regulatory requirements applicable to both swaps and security-based swaps. The CFTC believes that the cost of such dual regulation would likely be at least as great, if not greater, than the costs of the process set forth in proposed rule 1.9 to request an alternative regulatory treatment for such the mixed swap. The proposed rule regarding bilateral uncleared mixed swaps where at least one party is a dual registrant does not entail any additional costs, and may reduce costs for dual registrants that enter into such mixed swaps by eliminating potentially duplicative or inconsistent regulation.

b) Benefits.

The CFTC believes that the proposed rules that enable market participants to submit requests for joint interpretations regarding the nature of various agreements, contracts, or transactions, and requests for joint orders regarding the regulatory treatment of mixed swaps, will help to create a level playing field (since the joint interpretations and joint orders will be available to all market participants) regarding which agreements, contracts, or transactions constitute swaps, security-based swaps, or mixed swaps, and the regulatory treatment applicable to particular mixed swaps. The availability of such joint interpretations and joint orders regarding the scope of the definitions and the regulatory treatment of mixed swaps will reduce transaction costs and thereby promote the use of Title VII instruments and the efficient operation of the swap markets. This, in turn, is expected to encourage the use of Title VII instruments for risk management and other purposes. The separate proposed rule for bilateral uncleared mixed swaps where at least one party is dually registered should eliminate potentially duplicative and inconsistent regulation.

The CFTC requests comment as to the costs and benefits of the processes for seeking joint interpretations and joint orders in proposed rules 1.8 and 1.9, respectively, for market participants, markets, and the public.

6. Costs and Benefits of SBSA Books and Records, and Data, Requirements.

Proposed CFTC rule 1.7 under the CEA would clarify that there would not be books and records, or data, requirements regarding SBSAs other than those that would exist for swaps. The proposed rule alleviates any additional books and records or information costs to persons who are required to keep and maintain books and records regarding, or collect and maintain data regarding, SBSAs because the proposed rule does not require such persons to keep or maintain any books and records, or collect and maintain any data, regarding, SBSAs that differs from the books, records, and data required regarding swaps.

Specifically, proposed rule 1.7 would require persons registered as SDRs to: i) keep and maintain books and records regarding SBSAs only to the extent that SDRs are required to keep and maintain books and records regarding swaps; and ii) collect and maintain data regarding SBSAs only to the extent that SDRs are required to collect and maintain data regarding swaps. In addition, proposed rule 1.7 would require persons registered as swap dealers or major swap participants to keep and maintain books and records, including daily trading records, regarding SBSAs only to the extent that those persons would be required to keep and maintain books and records regarding swaps.

Because proposed rule 1.7 imposes no requirements with respect to SBSAs other than those that exist for swaps, proposed rule 1.7 would impose no costs other than those that are required with respect to swaps in the absence of proposed rule 1.7. Proposed rule 1.7 provides clarity by establishing uniform requirements regarding books and records, and data collection, requirements for swaps and for SBSAs.

The CFTC requests comment as to the costs and benefits of proposed rule 1.7 for market participants, markets, and the public.

7. Costs and Benefits of the Proposed Interpretive Guidance Regarding the Forward Contract Exclusion from the Swap Definition.

The CFTC is proposing interpretive guidance that the forward contract exclusion from the swap definition for nonfinancial commodities should be read consistently with the forward contract exclusion from the CEA definition of the term "future delivery." In that regard, the CFTC is proposing to retain the Brent Interpretation and extend it to apply to all nonfinancial commodities, and to withdraw the Energy Exemption which had extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil. The CFTC also is proposing that its prior guidance regarding commodity options embedded in forward contracts should be applied as well to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act.

The CFTC anticipates that its proposed interpretive guidance construing the forward contract exclusion consistently with respect to the definitions of the terms "swap" and "future delivery" in this manner will not impose any material costs on market participants. It also will establish a uniform interpretation of the forward contract exclusion for the definitions of both statutory terms, which will avoid the significant costs that some commenters stated would result if the forward contract exclusion were construed differently in these two contexts.[341]

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341 See EEI Letter ("Without legal certainty as to the regulatory treatment of their forward contracts, EEI's members and other end users who rely on the forward contract exclusion likely will face higher transaction costs due to greater uncertainty. These increased

The CFTC requests comment as to the costs and benefits of the proposed interpretative guidance regarding the forward contract exclusion from the swap definition, including the retention of the Brent Interpretation and its extension to all nonfinancial commodities and the withdrawal of the Energy Exemption, for market participant, markets, and the public.

8. Costs and Benefits of the Proposed Anti-Evasion Rules and Interpretive Guidance.

The CFTC is proposing to exercise the anti-evasion rulemaking authority granted to it by the Dodd-Frank Act. Generally, proposed CFTC rule 1.3(xxx)(6) under the CEA would define as a swap any agreement, contract, or transaction that is willfully structured to evade (or as an attempt to evade) the provisions of Title VII governing the regulation of swaps. Further, proposed CFTC rule 1.6 under the CEA would prohibit activities conducted outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade any provision of the CEA as enacted by Title VII or the rules and regulations promulgated thereunder.

As opposed to providing a bright-line test, proposed rule 1.3(xxx)(6) would apply to agreements, contracts, and transactions, and proposed rule 1.6 would apply to agreements, contracts, transactions and entities, that are willfully structured to evade (or as an attempt to evade) the provisions of Title VII governing the regulation of swaps. Although this test does not provide a bright line, it helps ensure that would-be evaders

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transaction costs may include: (i) more volatile or higher commodity prices; and (ii) increased credit costs, in each case caused by changes in market liquidity as end users' change the way they transact in the commodity markets. A single regulatory approach that uses the same criteria to confirm that a forward contract is excluded from the Commission's jurisdiction over swaps and futures will reduce this uncertainty and the associated costs to end users." (footnote omitted)).

cannot intentionally structure their transactions or entities for the sole purpose of evading the requirements of Title VII. The CFTC also is proposing interpretive guidance as to certain types of circumstances that may constitute an evasion of the requirements of Title VII, while at the same time preserving the CFTC's ability to determine, on a case-by-case basis, that other types of transactions or actions constitute an evasion of the requirements of the statute or the regulations promulgated thereunder. This will promote the enforcement of the anti-evasion rules in a manner that does not inappropriately interfere with activities undertaken for legitimate business purposes.

Absent the proposed anti-evasion rules and interpretive guidance, price discovery would be impaired because markets would not be informed about those transactions. Additionally, systemic risk could increase in a manner that the CFTC would not be able to measure accurately. The proposed anti-evasion rules and interpretive guidance will bring the appropriate scope of transactions and entities within the regulatory framework established by the Dodd-Frank Act, which will better allow the CFTC to assure transparency and address systemic risk.

Request for Comment:

148. After considering the costs and benefits of the proposed rules and interpretive guidance as discussed in this section, the CFTC has determined to issue the proposal. The CFTC invites public comment on all of its cost-benefit considerations. Commenters are requested to submit empirical data or other factual information quantifying or qualifying the costs and benefits of the proposed rules and interpretive guidance with their comments, to the extent possible.

D. Consideration of Impact on the Economy.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996

("SBREFA")[342] the CFTC must advise the Office of Management and Budget as to whether the proposed rules constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: i) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); ii) a major increase in costs or prices for consumers or individual industries; or iii) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The CFTC does not believe that any of the proposed rules in this release, in their current form, would constitute a major rule.

The CFTC requests comment on the potential impact of the proposed rules on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

IX. Administrative Law Matters – Exchange Act Revisions.

A. Paperwork Reduction Act.

1. Background.

Proposed rules 3a68-2 and 3a68-4(c) would contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[343] The SEC is submitting them to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[344] An agency may not conduct or sponsor, and a

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[342] Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[343] 44 U.S.C. 3501 et seq.

[344] 44 U.S.C. 3507(d) and 5 CFR 1320.11

person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the new collection of information.

These proposed rules contain collections and are being proposed pursuant to the Exchange Act. The proposed rules would establish a process through which a person could submit a request to the Commissions that the Commissions provide a joint interpretation of whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap). The rules also would establish a process with respect to mixed swaps through which a person could submit a request to the Commissions that the Commissions issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. The hours and costs associated with preparing and sending these requests would constitute reporting and cost burdens imposed by each collection of information.

2. Summary of Collection of Information Under Proposed Rules 3a68-2 and 3a68-4(c).

The SEC is proposing new rules that would allow persons to submit requests to the Commissions for joint interpretations regarding whether a particular agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap), and for joint orders permitting alternative regulatory treatment for particular mixed swaps.

First, the SEC is proposing new rule 3a68-2, which would allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract, or transaction (or a class thereof) is a swap, security-based swap, or both (i.e., a mixed swap). Under proposed rule 3a68-2, a person would provide to the Commissions a copy of all material information regarding the terms of, and a statement of the economic characteristics and purpose of, each relevant agreement, contract, or transaction (or class thereof), along with that person's determination as to whether each such agreement, contract, or transaction (or class thereof) should be characterized as a swap, security-based swap, or both (i.e., a mixed swap). The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint interpretation or joint notice of proposed rulemaking regarding the status of that agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (i.e., a mixed swap). Any joint interpretation, like any joint notice of proposed rulemaking, will be public and may discuss the material information regarding the terms of the relevant agreement, contract, or transaction (or class thereof), as well as any other information the Commissions deem material to the interpretation.

Requesting persons also would be permitted to withdraw a request made pursuant to proposed rule 3a68-2 at any time before the Commissions have issued a joint interpretation or joint notice of proposed rulemaking in response to the request. Regardless of a particular request for interpretation, however, the Commissions could provide such a joint interpretation or joint notice of proposed rulemaking of their own accord.

Persons would submit requests pursuant to proposed rule 3a68-2 on a voluntary basis. However, if a person submits a request, all of the information required under the proposed rule, including any additional information requested by the Commissions, must be submitted to the Commission, except to the extent a person withdraws the request pursuant to the proposed rule.

For purposes of the PRA, the SEC estimates that the total annual paperwork burden resulting from proposed rule 3a68-2 would be approximately 20 hours of internal company or individual time and a cost of approximately $9,480 for the services of outside professionals that the SEC believes would consist of services provided by attorneys.[345] As discussed further below, these total costs include all collection burdens associated with the proposed rules, including burdens related to the initial determination requirements.

Second, the SEC is proposing new rule 3a68-4(c), which would allow persons to submit requests to the Commissions for joint orders regarding the regulation of a particular mixed swap (or class thereof). Under proposed rule 3a68-4(c), a person would provide to the Commissions a copy of all material information regarding the terms of, and the economic characteristics and purpose of, the specified (or specified class of) mixed swap. In addition, a person would provide the specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for relevant mixed swap (or class thereof), and an analysis of: i) the nature and purposes

345 For convenience, the estimated PRA hour burdens have been rounded to the nearest whole dollar. Data from SIFMA's "Management & Professional Earnings in the Securities Industry 2009," modified by SEC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead, suggest that that the cost of an attorney is $316 per hour.

of the parallel provisions that are the subject of the request; ii) the comparability of such parallel provision; and iii) the extent of any conflicts or differences between such parallel provisions. The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint order, after public notice and opportunity for comment, providing that the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap (or class thereof)) is permitted to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. Any joint order will be public and may discuss the material information regarding the terms of the mixed swap (or class thereof), as well as any other information the Commissions deem material to the order. Requesting persons also would be permitted to withdraw a request made pursuant to proposed rule 3a68-4(c) at any time before the Commissions have issued a joint order in response to the request.

Persons would submit requests pursuant to proposed rule 3a68-4(c) on a voluntary basis. However, if a person submits a request, all of the information required under the proposed rule, including any additional information requested by the Commissions, must be submitted to the Commission, except to the extent a person withdraws the request pursuant to the proposed rule.

For purposes of the PRA, the SEC estimates that the total annual incremental paperwork burden resulting from proposed rule 3a68-4(c) would be approximately 30 hours of internal company or individual time and a cost of approximately $15,800 for the services of outside professionals, which the SEC believes would consist of services provided by attorneys.[346] As discussed further below, these total costs include all collection burdens associated with the proposed rules, including burdens related to the initial determination requirements.

3. Proposed Use of Information.

The SEC would use the information collected pursuant to proposed rule 3a68-2 to evaluate an agreement, contract, or transaction (or class thereof) in order to provide joint interpretations or joint notices of proposed rulemaking with the CFTC regarding whether these agreements, contracts, or transactions (or classes thereof) are swaps, security-based swaps, or both (i.e., mixed swaps) as defined in the Dodd-Frank Act. The SEC would use the information collected pursuant to proposed rule 3a68-4(c) to evaluate a specified, or a specified class of, mixed swaps in order to provide joint orders or joint notices of proposed rulemaking with the CFTC regarding the regulation of that particular mixed swap or class of mixed swap. The information provided to the SEC pursuant to proposed rules 3a68-2 and 3a68-4(c) also would allow the SEC to monitor the development of new OTC derivatives products in the marketplace and determine whether additional rulemaking or interpretive guidance is necessary or appropriate.

4. Respondents.

It is difficult to calculate the precise number of requests that would be submitted to the Commissions under proposed rules 3a68-2 and 3a68-4(c), given the historical unregulated state of the OTC derivatives market. Although any person could submit a

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346 See supra note 345.

request under proposed rule 3a68-2, the SEC believes as a practical matter that the relevant categories of such persons would be swap dealers and security-based swap dealers, major swap participants and major security-based swap participants, SEFs, security-based SEFs, DCOs clearing swaps, DCMs trading swaps, SDRs, SBSDRs, and clearing agencies clearing security-based swaps, and the total number of persons could be 475.[347] Similarly, although any person could submit a request under proposed rule 3a68-4(c), the SEC believes as a practical matter that the relevant categories of such persons would be SEFs, security-based SEFs, and DCMs trading swaps, and the total number of persons could be 72.[348]

However, based on the SEC's experience and information received from commenters to the ANPR[349] and during meetings with the public to discuss the Product Definitions generally, including the interpretation of whether a transaction is a swap,

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347 This total number includes an estimated 250 swap dealers, 50 major swap participants, 50 security-based swap dealers, 10 major security-based swap participants, 35 SEFs, 20 security-based SEFs, 12 DCOs, 17 DCMs, 15 SDRs, 10 SBSDRs, and 6 clearing agencies, as set forth by the CFTC and SEC, respectively, in their other Dodd-Frank Act rulemaking proposals. See Entity Definitions, supra note 12 (regarding security-based swap dealers and major security-based swap participants); Registration of Swap Dealers and Major Swap Participants, supra note 330 (regarding swap dealers and major security-based swap participants); Security-Based Swap Data Repository Registration, Duties, and Core Principles, supra note 6 (regarding SBSDRs); Swap Data Repositories, supra note 330 (regarding SDRs); Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214, Jan. 7, 2011 (regarding SEFs); Registration and Regulation of Security-Based Swap Execution Facilities, 76 FR 10948, Feb. 28, 2011 (regarding security-based SEFs); Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 63113, Oct. 14, 2010 (regarding DCOs); Information Management Requirements for Derivatives Clearing Organizations, 75 FR 78185, Dec. 15, 2010 (regarding DCOs); Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698, Jan. 20, 2011 (regarding DCOs); Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572, Dec. 22, 2010 (regarding DCMs); Clearing Agency Standards for Operation and Governance, 76 FR 14472, Mar. 16, 2011 (regarding clearing agencies).

348 Id.

349 See supra note 283 and accompanying text.

security-based swap, or both (i.e., a mixed swap), and taking into consideration the certainty provided by the proposed rules and interpretive guidance in this release, the SEC believes that the number of requests that would be submitted by such persons to the Commissions to provide joint interpretations as to whether a given agreement, contract, or transaction is a swap, security-based swap, or both (i.e., a mixed swap), would be small, and therefore expects that only a small number of requests would be submitted pursuant to proposed rule 3a68-2. With respect to proposed rule 3a68-4(c), the SEC also estimates the number of requests for joint orders would be small.[350] Pursuant to the Commissions' proposed rules and interpretive guidance, a number of persons that engage in agreements, contracts, or transactions that are swaps, security-based swaps, or both (i.e., a mixed swap) would be certain that their transactions are, indeed, swaps, security-based swaps, or both, (i.e., a mixed swap) and would not request an interpretation pursuant to proposed rule 3a68-2. Also, as the Commissions provide joint interpretations regarding whether agreements, contracts, or transactions (or classes thereof) are or are not swaps, security-based swaps, or both (i.e., mixed swaps), the SEC expects that the number of requests for interpretation will decrease over time. The SEC believes that the rules and interpretive regarding swaps, security-based swaps, and mixed swaps the Commissions are proposing, as well as the additional guidance issues pursuant to joint interpretations and orders under proposed rules 3a68-2 and 3a68-4 will result in a narrow

[350] See discussion supra part IV.A.

pool of potential respondents, approximately 50,[351] to the collection of information requirements of proposed rule 3a68-2.

Similarly, because the SEC believes that both the category of mixed swap transactions and the number of market participants that engage in mixed swap transactions are small, the SEC believes that the pool of potential persons requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap pursuant to proposed rule 3a68-4(c) would be small (approximately 10[352]). Also, those requests submitted pursuant to proposed rule 3a68-2 that result in an interpretation that the agreement, contract, or transaction (or class thereof) is not a mixed swap would reduce the pool of possible persons submitting a request regarding the regulation of particular mixed swaps (or class thereof) pursuant to proposed rule 3a68-4(c). In addition, not only the requesting party, but also any other person or persons that subsequently lists, trades, or clears that mixed swap, would be subject to, and must comply with, the joint order regarding the regulation of the specified, or specified class of, mixed swap, as issued by the Commissions. Therefore, the SEC believes that the number of requests for a joint order regarding the regulation of mixed swaps, particularly involving specified classes of mixed would decrease over time.

The SEC seeks comment on the number of persons that potentially would submit requests pursuant to rules 3a68-2 and 3a68-4(c).

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351 The SEC believes that there would be approximately 50 requests in the first year. See discussion infra part IX.A.5. The SEC recognizes that one person might submit more than one request, but for purposes of the PRA is considering each such request as one person in order to provide a more conservative estimate of the number of persons that would be subject to paperwork burdens.

352 See id.

5. Paperwork Reduction Act Burden Estimates.

Proposed rules 3a68-2 and 3a68-4(c) would, if adopted, require submission of certain information to the Commissions to the extent persons elect to request an interpretation and/or alternative regulatory treatment. Proposed rules 3a68-2 and 3a68-4(c) each requite the information that a requesting party must include in its request to the Commissions in order to receive a joint interpretation or order, as applicable.

a) Proposed Rule 3a68-2.

Proposed rule 3a68-2 would require any party requesting a joint interpretation under the rule to include disclosures about the agreement, contract, or transaction (or class thereof) in question as well as a statement of economic purpose and the requesting party's initial determination regarding whether the agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap). The proposed rule would apply only to requests made by persons that desire an interpretation from the Commissions. For each agreement, contract, or transaction (or class thereof) for which a person requests the Commissions' joint interpretation, the requesting person would be required to provide a copy of all material information regarding the applicable terms; a statement of the economic characteristics and purpose; and the requesting person's determination as to whether such agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap), including the basis for the requesting person's determination. The requesting person also would be required to provide such other information as the Commissions may request.

As discussed above, the SEC believes the number of persons that would submit requests pursuant to proposed rule 3a68-2 is quite small given the proposed rules and interpretive guidance regarding swaps, security-based swaps, and mixed swaps the

Commissions are providing.[353] Although the SEC does not have precise figures for the number of requests that persons would submit, the SEC believes it is reasonable to estimate that it likely would be fewer than 50 requests in the first year. For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a person's request to the Commissions pursuant to proposed rule 3a68-2 would be 20 hours per request and associated costs of $9,480.[354] Assuming 50 requests in the first year, the SEC estimates that this would result in an aggregate burden for the first year of 1000 hours of company time (50 requests x 20 hours/request) and $474,000 for the services of outside professionals (e.g., attorneys) (50 requests x 30 hours/request x $316).

As discussed above, the SEC believes that as the Commissions provide joint interpretations or joint notices of proposed rulemaking, the number of requests received will decrease over time. Although the SEC does not have precise figures for the number of requests that persons would submit after the first year, the SEC believes it is reasonable to estimate that it likely would be fewer than 10 requests on average in ensuing years. Assuming 10 requests in ensuing years, the SEC estimates that this would

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353 This estimate is based on comments from and discussions with market participants regarding uncertainty concerning whether certain contracts might be considered swaps, security-based swaps, or both, i.e., mixed swaps, and the size of the mixed swaps category, although the SEC has not received data regarding the specific number of potential transaction types for which there is uncertainty or that are mixed swaps.

354 This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products were securities, which the SEC believes is a process similar to the process under proposed rule 3a68-2, was approximately 20 hours and associated costs of $9,480. Assuming these costs correspond to legal fees, which we estimate at an hourly cost of $316, we estimate that this cost is equivalent to approximately 30 hours ($9,480/$316).

result in an aggregate burden in each ensuing year of 200 hours of company time (10 requests x 20 hours/request) and $94,800 for the services of outside professionals (e.g., attorneys) (10 requests x 30 hours/request x $316).

b) Proposed Rule 3a68-4(c).

Proposed rule 3a68-4(c) would require any party requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap under the rule to include disclosure about the agreement, contract, or transaction (or class thereof) that is a mixed swap as well as a statement of economic purpose for the mixed swap (class thereof). In addition, a person would provide the specified parallel provisions that the person believes should apply to the mixed swap (or class thereof), the reasons the person believes the specified parallel provisions would be appropriate for the mixed swap, and an analysis of: i) the nature and purposes of the parallel provisions that are the subject of the request; ii) the comparability of such parallel provisions; and iii) the extent of any conflicts or differences between such parallel provisions. The requesting person also would be required to provide such other information as the Commissions may request.

As discussed above, the SEC believes the number of requests that persons would submit pursuant to proposed rule 3a68-4(c) is quite small given the limited types of agreements, contracts, or transactions (or class thereof) the Commissions believe would constitute mixed swaps.[355] In addition, depending on the characteristics of a mixed swap (or class thereof), a person may choose not to submit a request pursuant to proposed rule 3a68-4(c). The SEC also notes that any joint order issued by the Commissions would apply to any person that subsequently lists, trades, or clears that specified, or specified

355 See supra note 283 and accompanying text.

class of, mixed swap, so that requests for joint orders could diminish over time. Also, persons may submit requests for an interpretation under proposed rule 3a68-4(c) that do not result in an interpretation that the agreement, contract, or transaction (or class thereof) is a mixed swap. Therefore, although the SEC does not have precise figures for the number of requests that persons would submit, the SEC believes it is reasonable to estimate that it likely would be fewer than 20 requests in the first year. For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a party's request to the Commissions pursuant to proposed rule 3a68-4(c) would be 30 hours and associated costs of $15,800 per request for mixed swaps for which a request for a joint interpretation pursuant to proposed rule 3a68-4(c) was not previously made.[356] Assuming 20 requests in the first year, the SEC estimates that this would result in an aggregate burden for the first year of 600 hours of company time (20 requests x 30 hours/request) and $316,000 for the services of outside professionals (20 requests x 50 hours/request x $316).

For mixed swaps for which a request for a joint interpretation pursuant to proposed rule 3a68-2 was previously made, the SEC estimates the total paperwork burden under the PRA associated with preparing and submitting a party's request to the Commissions pursuant to proposed rule 3a68-4(c) would be 10 hours fewer and $4,740 less per request than for mixed swaps for which a request for a joint interpretation

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[356] This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the regulatory treatment of certain securities products which the SEC believes is a process similar to the process under proposed rule 3a68-4(c), was approximately 30 hours and associated costs of $15,800. Assuming these costs correspond to legal fees, which we estimate at an hourly cost of $316, we estimate that this cost is equivalent to approximately 50 hours ($15,800/$316).

pursuant to proposed rule 3a68-2 was not previously made because certain, although not all, of the information required to be submitted and necessary to prepare pursuant to proposed rule 3a68-4(c) would have been required to be submitted and necessary to prepare pursuant to proposed rule 3a68-2.[357] Although certain requests made pursuant to proposed rule 3a68-4(c) may be made without a previous request for a joint interpretation pursuant to proposed rule 3a68-2, the SEC believes that most requests under proposed rule 3a68-2 that result in the interpretation that an agreement, contract, or transaction (or class thereof) is a mixed swap will result in a subsequent request for alternative regulatory treatment pursuant to proposed rule 3a68-4(c). Assuming, therefore, that 90 percent, or 18 of the estimated 20 requests pursuant to proposed rule 3a68-4(c) in the first year, as discussed above, would be such "follow-on" requests, the SEC estimates that this would result in an aggregate burden in the first year of 360 hours of company time (18 requests x 20 hours/request) and $199,080 for the services of outside professionals (18 requests x 35 hours/request x $316).

As discussed above, the SEC believes that as the Commissions provide joint orders regarding alternative regulatory treatment, the number of requests received will decrease over time. The SEC believes it is reasonable to estimate that it likely would be fewer than 5 requests on average in ensuing years. Assuming 5 requests in ensuing years, the SEC estimates that this would result in an aggregate burden in each ensuing year of

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357 This estimate takes into account that certain information regarding the mixed swap (or class thereof), namely the material terms and the economic purpose, will have already been gathered and prepared as part of the request submitted pursuant to proposed rule 3a68-2. The SEC estimates that these items constitute approximately 10 hours fewer and a reduction in associated costs of $4,740. Assuming these costs correspond to legal fees, which we estimate at an hourly cost of $316, we estimate that this cost is equivalent to approximately 15 hours ($4,740/$316).

150 hours of company time (5 requests x 30 hours/request) and $79,000 for the services of outside professionals (5 requests x 50 hours/request x $316). As discussed above, assuming that approximately 90 percent, or 4 of the estimated 5 requests pursuant to proposed rule 3a68-4(c) in ensuing years would be "follow-on" requests to requests for joint interpretation from the Commissions under proposed rule 3a68-4(c), the SEC estimates that this would result in an aggregate burden in each ensuing year of 80 hours of company time (4 requests x 20 hours/request) and $44,240 for the services of outside professionals (4 requests x 35 hours/request x $316).

Request for Comment:

Pursuant to 44 U.S.C. 3506(c)(2)(B), the SEC solicits comments to: i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; ii) evaluate the accuracy of the SEC's estimate of burden of the proposed collection of information; iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and iv) evaluate whether there are ways to minimize the burden of the collection of information on those that are to respond, including through the use of automated collection techniques or other forms of information technology. In addition, the SEC requests comment on the accuracy of the estimates regarding the total paperwork burden.

In particular, the SEC requests comment for purposes of the PRA on the following:

149. How many requests for a joint interpretation from the Commissions would be submitted pursuant to rule 3a68-2?

150. How many requests for a joint order from the Commissions would be submitted pursuant to rule 3a68-4(c)?

151. How many requests for a joint order from the Commissions would be submitted pursuant to rule 3a68-4(c) regarding the same agreement, contract, or transaction (or class thereof) that was the subject of a request for a joint interpretation from the Commissions submitted pursuant to rule 3a68-2?

152. Are the paperwork burden estimates, for both company time and outside services, as discussed above accurate? Do these estimates reflect the paperwork burdens and costs associated with requests made pursuant to proposed rules 3a68-2 and 3a68-4(c)?

Commenters should, when possible, provide empirical data to support their views.

Any member of the public may direct to us or to OMB any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burdens. Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-16-11. Requests for materials submitted to OMB by the SEC with regard to these collections of information should be in writing, refer to File No. S7-16-11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street NE, Washington, DC 20549-0213. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best ensured of having its full effect if OMB receives it within 30 days of publication.

B. Cost-Benefit Analysis.

1. Background.

Title VII establishes a regulatory framework for OTC derivatives. As part of that framework, Title VII amends the CEA and the Exchange Act to broadly categorize covered derivative products as swaps, security-based swaps, SBSAs, and/or mixed swaps. In particular, section 712(d)(1) of the Dodd-Frank Act provides that the Commissions, in consultation with the Board, shall jointly further define, among other things, the terms "swap," "security-based swap," and "security-based swap agreement." Section 712(a)(8) of the Dodd-Frank Act provides further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII. In addition, sections 712(d)(2)(B) and (C) of the Dodd-Frank Act require the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs for SDRs that are registered under the CEA, swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.

The Product Definitions and the regulation of mixed swaps are part of the Dodd-Frank Act's comprehensive framework for regulating the swaps markets whereby the CFTC is given regulatory authority over "swaps,"[358] the SEC is given regulatory authority over "security-based swaps,"[359] and the Commissions shall jointly prescribe

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358 See CEA section 1a(47), 7 U.S.C. 1a(47) (cross-referenced in section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69)).

359 See section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68) (cross-referenced in CEA section 1a(42), 7 U.S.C. 1a(42)).

such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.[360] In addition, the SEC is given antifraud authority over, and access to information from certain CFTC-regulated entities (e.g., DCOs, SEFs, and swap dealers) regarding, SBSAs.[361]

In most instances, the Commissions' proposed rules and guidance merely clarify the application of the Product Definitions to specific products as is required by the relevant provisions of the CEA and Exchange Act, as modified by the Dodd-Frank Act and the regulation of mixed swaps. However, for some of the rules the Commissions are proposing, the Commissions are exercising their discretion to further define the Product Definitions and to regulate mixed swaps, which would generate costs and benefits to market participants. The Commissions also are fulfilling the requirement in Dodd-Frank that they establish requirements regarding books and records with respect to SBSAs, which also would generate costs and benefits to market participants. The costs and benefits regarding these rules are discussed below.

2. Proposed Rule 3a68-1a.

a) Benefits.

A security-based swap includes a swap that is based on the "occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations

360 See CEA section 1a(47)(D), 7 U.S.C. 1a(47)(D); section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(68)(D).

361 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78); CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v).

of the issuer" (the "Event Provision").[362] Proposed rule 3a68-1a would provide that, solely for purposes of determining whether a CDS is a security-based swap under the Event Provision, the term "issuers of securities in a narrow-based security index" would have the meaning as set forth in proposed rule 3a68-1a.

Because index CDS typically are written on indexes of entity names, not on indexes of the specific securities of those entities, the Commissions are concerned that the application of the Event Provision, without further clarification, may cause uncertainty about whether certain index CDS would be security-based swaps or swaps. Therefore, proposed rule 3a68-1a would eliminate the potential uncertainty of the treatment of index CDS as either security-based swaps or swaps by setting forth clear and objective criteria for meeting the definition of "issuers of securities in a narrow-based security index" and therefore being a security-based swap.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68-1a. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68-1a.

b) Costs.

In complying with proposed rule 3a68-1a, a market participant will need to ascertain whether an index CDS is a security-based swap or swap according to the criteria set forth for meeting the definition of "issuers of securities in a narrow-based security index." This analysis will have to be performed by market participants upon entering into an index CDS to determine whether the index CDS is subject to the SEC's regulatory regime for security-based swaps or the CFTC's regulatory regime for swaps. The SEC

362 Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

notes, however, that any such costs would be in lieu of the costs of doing the same analysis under the statutory security-based swap definition. Because the statutory security-based swap definition lacks the specificity provided by proposed rule 3a68-1a, the SEC believes analysis of an index CDS would under proposed rule 3a68-1a would lead to less uncertainty than would the same analysis under the statutory security-based swap definition. Providing a clear rule to persons to determine whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Exchange Act[363] could alleviate additional costs to persons of inquiring with the Commissions about whether an index CDS is a swap or security-based swap under that provision, as well as costs of obtaining an opinion of counsel regarding the applicability of that provision to a particular index CDS.

In addition, proposed rule 3a68-1a is generally consistent with the definition of "narrow-based security index" that exists in section 3(a)(55)(B) of the Exchange Act, as modified to address debt securities in the context of security futures.[364] Because some market participants are familiar with this definition, as well as with performing analyses of products in the security futures context based on this definition, the SEC believes that the proposed definition of "issuers of securities in a narrow-based security index" will mitigate uncertainty for those market participants regarding the treatment of index CDS. In addition, because such market participants would be familiar with many of the criteria in proposed rule 3a68-1a, such market participants would require less time and effort, and

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363 15 U.S.C. 78c(a)(68)(A)(ii)(III).

364 See July 2006 Rules, supra note 199.

thus incur less cost, in determining the scope and applicability of such criteria to the determination of whether an index CDS is a swap or security-based swap.

The SEC requests comment as to the costs that determinations under proposed rule 3a68-1a would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68-1a that have not been considered and what the extent of those costs would be.

3. Proposed Rule 3a68-1b.

a) Benefits.

A security-based swap includes a swap that is based on "an index that is a narrow-based security index, including any interest therein or on the value thereof."[365] Proposed rule 3a68-1b would provide that, solely for purposes of determining whether a CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange Act,[366] the term "narrow-based security index" would have the meaning as set forth in proposed rule 3a68-1b.

Because index CDS may be written in indexes of the specific securities of entities as well as on indexes of entity names, the Commissions are concerned that the application of section 3(a)(68)(A)(ii)(I) of the Exchange Act,[367] without further clarification, may cause uncertainty about whether certain index CDS would be security-based swaps or swaps. Therefore, proposed rule 3a68-1b would eliminate the potential uncertainty of the treatment of index CDS as either security-based swaps or swaps by

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365 Section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I).

366 15 U.S.C. 78c(a)(68)(A)(ii)(I).

367 15 U.S.C. 78c(a)(68)(A)(ii)(I).

setting forth clear and objective criteria for meeting the definition of "narrow-based security index" and therefore being a security-based swap.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68-1b. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68-1b.

b) Costs.

In complying with proposed rule 3a68-1b, a market participant will need to ascertain whether an index CDS is a security-based swap or swap according to the criteria set forth for meeting the definition of "narrow-based security index." This analysis will have to be performed by market participants upon entering into an index CDS to determine the whether the index CDS is subject to the SEC's regulatory regime for security-based swaps or the CFTC's regulatory regime for swaps. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis under the statutory security-based swap definition. Because the statutory security-based swap definition lacks the specificity provided by proposed rule 3a68-1b, the SEC believes analysis of an index CDS would under proposed rule 3a68-1b would lead to less uncertainty than would the same analysis under the statutory security-based swap definition. Providing a clear rule to persons to determine whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange Act[368] could alleviate additional costs to persons of inquiring with the Commissions about whether an index CDS is a swap or security-based swap under that provision, as well as costs of

[368] 15 U.S.C. 78c(a)(68)(A)(ii)(I).

obtaining an opinion of counsel regarding the applicability of that provision to a particular index CDS.

In addition, proposed rule 3a68-1b is generally consistent with the definition of "narrow-based security index" that exists in section 3(a)(55)(B) of the Exchange Act, as modified to address debt securities in the context of security futures.[369] Because some market participants are familiar with this definition, as well as with performing analyses of products in the security futures context based on this definition, the SEC believes that the proposed definition of "narrow-based security index" will mitigate uncertainty for those market participants regarding the treatment of index CDS. In addition, because such market participants would be familiar with many of the criteria in proposed rule 3a68-1b, such market participants would require less time and effort, and thus incur less cost, in determining the scope and applicability of such criteria to the determination of whether an index CDS is a swap or security-based swap.

The SEC requests comment as to the costs that determinations under proposed rule 3a68-1a would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68-1a that have not been considered and what the extent of those costs would be.

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[369] See July 2006 Rules, supra note 199.

4. Proposed Rule 3a68-2.

a) Benefits.

Proposed rule 3a68-2 would establish a process for persons to request an interpretation of whether an agreement, contract, or transaction (or class of agreements, contracts, or transactions) is a swap, security-based swap, or both (i.e., a mixed swap).

Proposed rule 3a68-2 would afford persons with the opportunity to obtain greater certainty from the Commissions regarding whether certain products are swaps, security-based swaps, or both, i.e., mixed swaps. The SEC believes that this provision would decrease the possibility that market participants inadvertently might violate regulatory requirements regarding products that may constitute swaps, security-based swaps, or mixed swaps, which could lead to enforcement action. It also would decrease the likelihood that products might fall into regulatory gaps by providing a method for market participants to seek interpretations regarding the status of products for which the applicable regulatory regime might otherwise remain uncertain. In addition, the SEC believes the proposed rule will provide the opportunity for financial innovation by providing a flexible structure that will allow for the development of new products that otherwise might be hindered by the lack of regulatory certainty.

b) Costs.

Under proposed rule 3a68-2, a person could request the Commissions to provide an interpretation of whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or mixed swap. The SEC estimates that the cost of requesting this interpretation for a particular agreement, contract, or transaction (or class thereof) would be approximately 20 hours of internal company or individual time and a cost of approximately $9,480 for the services of outside professionals.[370] The SEC notes, however, that any such costs are in lieu of the costs of doing the same analysis without requesting the Commissions to provide an interpretation. In addition, as noted above, if the Commissions provide an interpretation pursuant to a request under proposed rule 3a68-2, a market participant, and other market participants that desire to transact in the same (or same class of) agreement, contract, or transaction, would have regulatory certainty about whether that agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap).

Also, the SEC believes that as persons make requests for interpretations about whether agreements, contracts, or transactions (or classes thereof agreements) are swaps, security-based swaps, or both, i.e., mixed swaps, pursuant to proposed rule 3a68-2, the subsequent costs for persons transacting in those products for which the Commissions have provided interpretations should be reduced.

The SEC requests comment as to the costs that proposed rule 3a68-2 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68-2 that have not been considered herein and what the extent of those costs would be.

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370 See discussion supra part VIII.

5. Proposed Rule 3a68-3.

a) Benefits.

Proposed rule 3a68-3 would provide that, except as otherwise provided in proposed rule 3a68-3, for purposes of section 3(a)(68) of the Exchange Act,[371] the term "narrow-based security index" has the meaning set forth in section 3(a)(55) of the Exchange Act,[372] and the rules, regulations, and orders of the SEC thereunder. This definition would eliminate potential uncertainty regarding the treatment of a narrow-based security index to which section 3(a)(55) of the Exchange Act also applies.[373]

Proposed rule 3a68-3 also would provide a tolerance period for the definition of "narrow-based security index" to ensure that, under certain conditions, a security index underlying a swap will not be considered a narrow-based security index and a security index underlying a security-based swap will be considered a narrow-based security index, even when the security index underlying the swap or security-based swap temporarily assumes characteristics that would render it a narrow-based security index or not a narrow-based security index, respectively. In addition, proposed rule 3a68-3 would provide for an additional 3-month grace period applicable to a security index that becomes narrow-based, or broad-based, as applicable, for more than 45 business days over 3 consecutive calendar months.

Because security indexes underlying Title VII instruments may migrate from narrow-based to broad-based, or vice versa, the Commissions are concerned that application of the narrow-based security index definition, without further clarification,

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371 15 U.S.C. 78c(a)(68).

372 15 U.S.C. 78c(a)(55).

373 15 U.S.C. 78c(a)(55).

may cause uncertainty regarding treatment of Title VII instruments traded on trading platforms when such migration has occurred. Therefore, proposed rule 3a68-3 would eliminate the potential uncertainty of the treatment of such Title VII instruments by setting forth clear and objective criteria regarding the application of the narrow-based security index definition to security indexes that have migrated from narrow-based to broad-based or from broad-based to narrow-based.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68-3. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68-3.

b) Costs.

In complying with proposed rule 3a68-3, a market participant will need to ascertain whether a security index underlying a Title VII instrument is narrow-based or broad-based according to the criteria set forth for the tolerance periods and grace periods in the proposed rule. This analysis would be performed upon entering into Title VII instrument on a security index to ensure compliance with proposed rule 3a68-3. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis under the narrow-based security index definition, which the SEC believes would be more difficult and lead to greater uncertainty, rather than the clarity provided under proposed rule 3a68-3. Providing a clear rule to market participants to determine whether a Title VII instrument traded on a trading platform where the underlying security index has so migrated could alleviate additional costs to persons of inquiring with the Commissions about whether a Title VII instrument is a swap or a security-based swap, as well as costs of obtaining an opinion of counsel regarding a particular Title VII instrument.

In addition, proposed rule 3a68-3 is generally consistent with the tolerance period and grace period that exist in section 3(a)(55) of the Exchange Act for futures contracts.[374] Because market participants are familiar with such tolerance period and grace period as well as with performing analyses of products in the futures context based on these provisions, the SEC believes that the proposed tolerance period and grace period in proposed rule 3a68-3 will mitigate uncertainty for market participants regarding the treatment of these Title VII instruments. Proposed rule 3a68-3 also would allow market participants to minimize the costs of determining whether a security index underlying a Title VII instrument is considered narrow-based or not by providing a test that is substantially similar to a test with which they are familiar in the futures context. In addition, the tolerance period under proposed rule 3a68-3 mitigates uncertainty for market participants trading Title VII instruments on trading platforms by allowing temporary migration of an underlying security index within certain specifications without disrupting the status of Title VII instruments based on that security index. Similarly, the grace period under proposed rule 3a68-3 mitigates uncertainty for market participants trading Title VII instruments on trading platforms by allowing time for any necessary actions to be made to accommodate the non-temporary migration of a security index underlying Title VII instruments.

The SEC requests comment as to the costs that determinations under proposed rule 3a68-3 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs

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[374] See supra note 261 and accompanying text.

associated with proposed rule 3a68-3 that have not been considered, and what the extent of those costs would be.

6. Proposed Rule 3a68-4.

a) Benefits.

A mixed swap is both a security-based swap and a swap, subject to dual regulation by the Commissions, and proposed rule 3a68-4 would define the term "mixed swap" in the same manner as the term is defined in both the Exchange Act.[375] Proposed rule 3a68-4 would also provide that a mixed swap that is not executed on or subject to the rules of a DCM, SEF, FBOT, NSE, or security-based SEF and that will not be submitted to a DCO or registered or exempt clearing agency to be cleared ("bilateral uncleared mixed swap"), and where at least one party to the mixed swap is registered with the SEC as a security-based swap dealer or major security-based swap participant and also with the CFTC as a swap dealer or major swap participant, shall be subject to the provisions of the Securities Act and the rules and regulations promulgated thereunder and only to certain provisions of the CEA and the rules and regulations promulgated thereunder. In addition, proposed rule 3a68-4 would establish a process for persons to request that such persons be permitted to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

Because, as noted above, mixed swaps are both swaps and security-based swaps, and thus are subject to regulation as both swaps and security-based swaps, the

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375 Section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(a)(68)(D); CEA section 1(a)(47)(D), 7 U.S.C. 1(a)(47)(D).

Commissions are concerned that, without further clarification, there may be uncertainty as to the scope of, and the requirements applicable to, transactions that fall within the definition of the term "mixed swap."

Proposed rule 3a68-4(a) would define the term "mixed swap" in the same manner as the term is defined in the Exchange Act. This rule, coupled with guidance regarding mixed swaps provided by the Commissions, further clarifies whether a security-based swap is a mixed swap and could eliminate the need to obtain an opinion of counsel regarding a particular security-based swap.

The Commissions are proposing rule 3a68-4(b) to eliminate potentially duplicative and conflicting regulation in the context of mixed swaps by providing that a bilateral uncleared mixed swap, where at least one party to the mixed swap is dually-registered with the SEC as a security-based swap dealer or major security-based swap participant and also with the CFTC as a swap dealer or major swap participant, would be subject to all applicable provisions of the securities laws (and SEC rules and regulations promulgated thereunder) but would be subject only to certain CEA provisions (and CFTC rules and regulations promulgated thereunder). Therefore, proposed rule 3a68-4(a) would reduce both the number of and potential uncertainty regarding which requirements of each Commission will apply to bilateral uncleared mixed swaps entered into by dually-registered dealers and major participants.

Proposed rule 3a68-4(c) also would afford persons with an opportunity to seek alternative regulatory treatment of a specified, or specified class of, mixed swap. Absent such alternative regulatory treatment, a person that desires or intends to list, trade, or clear a mixed swap would be required to comply with all the statutory provisions of Title

VII, including all the rules and regulations thereunder, that are applicable to both security-based swaps and swaps. The SEC believes that such a requirement could pose practical difficulties for mixed swap transactions[376] and that permitting persons to request alternative regulatory treatment of a specified, or specified class of, mixed swaps would allow the Commissions to address the potential for duplicative or contradictory regulatory requirements regarding a particular mixed swap.

The information submitted by persons pursuant to proposed rule 3a68-4(c) would assist the Commissions in more quickly identifying and addressing the relevant issues involved in providing alternative regulatory treatment.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a68-4. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a68-4.

b) Costs.

Providing a clear rule for persons who engage in bilateral uncleared mixed swaps would reduce the potential for duplicative or contradictory regulatory requirements that apply to such bilateral uncleared mixed swaps.

Under proposed rule 3a68-4(c), a person also could request the Commissions to provide alternative regulatory treatment of a specified, or specified class of, mixed swap. The SEC estimates that the cost of requesting alternative regulatory treatment for a particular mixedswap (or class thereof) would be approximately 30 hours of internal company or individual time and a cost of approximately $15,800 for the services of

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[376] See discussion supra part IV.

outside professionals.[377] The SEC notes, however, that any such costs are in lieu of the costs of complying with all the statutory provisions in Title VII, including all the rules and regulations thereunder, that are applicable to both security-based swaps and swaps, which the SEC believes would be more costly than requesting alternative regulatory treatment, and which potentially could pose practical difficulties.[378]

Also, the SEC believes that as persons make requests for alternative regulatory treatment of specified, or specified classes of, mixed swaps pursuant to proposed rule 3a68-4, the subsequent costs for persons transacting in those products for which the Commissions have provided for alternative regulatory treatment should be reduced.

The SEC requests comment as to the costs that proposed rule 3a68-4 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a68-4 that have not been considered herein, and what the extent of those costs would be.

7. Proposed Rule 3a69-1.

a) Benefits.

Proposed rule 3a69-1 would clarify that state or federally regulated insurance products provided by state or federally regulated insurance companies, or by certain reinsurers, provided such insurance products meet certain other requirements, would not be swaps. Specifically, proposed rule 3a69-1 would define the term "swap" so that it would not include an agreement, contract, or transaction that, by its terms or by law, as a

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377 See discussion supra part VIII.

378 See discussion supra part IV.B.

condition of performance on the agreement, contract, or transaction: i) requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; ii) requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest; iii) is not traded, separately from the insured interest, on an organized market or over-the-counter; and iv) with respect to financial guarantee insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer. Proposed rule 3a69-1 also would require that the agreement, contract, or transaction: i) be provided by a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner, or similar official or agency, of a state, as defined under section 3(a)(16) of the Exchange Act,[379] or by the United States or an agency or instrumentality thereof, and be regulated as insurance under the laws of such state or the United States; ii) be provided by the United States or any of its agents or instrumentalities, or pursuant to a statutorily authorized program thereof; or (iii) in the case of reinsurance only, be provided by a person located outside the United States to an insurance company that meets the above requirements, provided that such person is not prohibited by the law of any state or the United States from offering such agreement, contract, or transaction to such insurance company, the product to be

[379] 15 U.S.C. 78c(a)(16).

reinsured meets the requirements above for insurance products, and the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant. An agreement, contract, or transaction would have to meet all of these criteria in order to qualify as an insurance product that falls outside of the swap and security-based swap definitions pursuant to the proposed rules.

The SEC is concerned that, without further clarification, market participants may be uncertain about whether an agreement, contract, or transaction is an insurance product that is not subject to regulation as a swap or security-based swap. Therefore, proposed rule 3a69-1 would eliminate the potential uncertainty of what constitutes an insurance product by setting forth clear and objective criteria for meeting the definition of an insurance product that is not subject to regulation as a swap or security-based swap.

The SEC requests comments, data, and estimates regarding the benefits associated with proposed rule 3a69-1. The SEC also requests comments, data, and estimates regarding any additional benefits that could be realized with proposed rule 3a69-1.

b) Costs.

In complying with proposed rule 3a69-1, a market participant will need to analyze its agreements, contracts, and transactions that are insurance products under the provisions of the proposed rule to determine whether such insurance products fall outside the definitions of the terms "swaps" and "security-based swap." This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with proposed rule 3a69-1. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis absent proposed rule 3a69-1, which the SEC believes would be more difficult and lead to greater uncertainty than if the analysis were done under proposed rule 3a69-1. Providing an objective rule to determine whether an agreement, contract, or transaction is an insurance product could alleviate additional costs of inquiring with the Commissions about whether an agreement, contract, or transaction is an insurance product or a swap, or costs of obtaining an opinion of counsel regarding a particular agreement, contract, or transaction.

To the extent that the criteria under proposed rule 3a69-1 lead to the inadvertent omission of certain types of insurance products, these omissions could lead to costs for market participants entering into agreements, contracts, or transactions that might be omitted because these agreements, contracts, or transactions would be regulated as swaps and not as insurance products. Similarly, to the extent that the criteria under proposed rule 3a69-1 lead to the inadvertent inclusion of certain types of swaps or security-based swaps, these inclusions could lead to costs for market participants entering into agreements, contracts, or transactions that are regulated as insurance products and not as swaps or security-based swaps. The SEC has requested comment on whether the criteria under proposed rule 3a69-1 inadvertently omits certain types of insurance products or includes certain types of swaps in order to minimize these potential costs. The SEC believes that, pursuant to comments on the proposed criteria, any subsequent modifications the Commissions make to proposed rule 3a69-1 would significantly curtail the potential for inadvertent omissions or inclusions.

The SEC requests comment as to the costs that determinations under proposed rule 3a69-1 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a69-1 that have not been considered, and what the extent of those costs would be.

8. Proposed Rule 3a69-2.

a) Benefits.

Proposed rule 3a69-2 provides that the term "swap" has the meaning set forth in section 3(a)(69) of the Exchange Act and that, without limiting the definition of "swap" in section 3(a)(69) of the Exchange Act, an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, FRA, or NDF would fall within the meaning of the term "swap", unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA.[380] Proposed rule 3a69-2 also provides that a foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the CEA[381] and that, notwithstanding such provision, certain provisions of the CEA will apply to such foreign exchange forward or foreign exchange swap, namely the reporting requirements in section 4r of the CEA,[382] and regulations thereunder, and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA,[383] and regulations thereunder. In addition, proposed rule 3a69-2 provides that the terms "foreign exchange forward" and "foreign exchange swap" have the meanings set forth in the CEA and that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign

380 15 U.S.C. 78c(a)(69); 7 U.S.C. 1a(47)(B).

381 7 U.S.C. 1a(47)(E)(i).

382 7 U.S.C. 6r.

383 7 U.S.C. 6s.

exchange rate option, and NDF is not a foreign exchange forward or foreign exchange swap for purposes of sections 1a(24) and 1a(25) of the CEA.[384]

Proposed rule 3a69-2 would restate portions of the statutory definition of "swap" and enumerate certain types of agreements, contracts, and transactions that are swaps in order to consolidate parts of the definition and related interpretations for ease of reference. Proposed rule 3a69-2 would also specify certain reporting and business conduct requirements that are applicable to foreign exchange forwards and foreign exchange swaps, and provide definitions for such terms.

Because the statutory definition of the term "swap," though broadly worded and specific regarding the status of certain agreements, contracts, and transactions, does not explicitly mention every agreement, contract, or transaction that would fall within the definition, the Commissions are concerned that application of the definition, without further clarification, may cause uncertainty about whether certain agreements, contracts, or transactions would be swaps. Proposed rule 3a69-2 would eliminate the potential uncertainty of the treatment of such agreements, contracts, and transactions as swaps by setting forth clear and objective criteria for certain agreements, contracts, and transactions without limiting the scope of the statutory definition of the term "swap." Proposed rule 3a69-2 also would eliminate the potential uncertainty regarding the reporting and business conduct requirements applicable to foreign exchange forwards and foreign exchange swaps by specifying the provisions for which compliance is required.

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[384] 7 U.S.C. 1a(24) and 1a(25).

b) Costs.

In complying with proposed rule 3a69-2, a market participant will need to analyze its agreements, contracts, and transactions under the provisions of the proposed rule to determine whether such agreements, contracts, and transactions are swaps according to the criteria set forth in the proposed rule. This analysis will have to be performed upon entering into the agreement, contract, or transaction to ensure compliance with proposed rule 3a69-2. The SEC notes, however, that any such costs would be in lieu of the costs of doing the same analysis absent proposed rule 3a69-2, which the SEC believes would be more difficult and lead to greater uncertainty than if the analysis were done under proposed rule 3a69-2.

Providing an objective rule to market participants to determine whether certain types of agreements, contracts, or transactions are swaps could alleviate additional costs to persons of inquiring with the Commissions about whether such agreements, contracts, or transactions are swaps, as well as costs of obtaining an opinion of counsel regarding a particular agreement, contract, or transaction. In addition, an objective rule regarding reporting and business conduct requirements could alleviate additional costs to persons of inquiring with the Commissions about which reporting and business conduct requirements are applicable to foreign exchange forwards and foreign exchange swaps, and could reduce the costs of obtaining an opinion of counsel regarding a particular foreign exchange forward or foreign exchange swap.

To the extent that the criteria under proposed rule 3a69-2 lead to the inadvertent inclusion of certain types of agreements, contracts, and transactions or additional reporting or business conduct obligations for certain swaps, these inclusions and additional requirements could lead to costs for market participants entering into agreements, contracts, or transactions to which proposed rule 3a69-2 applies. The SEC has requested comment on whether the criteria under proposed rule 3a69-2 provide sufficient clarity regarding the specific products included in the rule and whether the criteria should clarify the applicability of reporting and business conduct requirements in order to minimize these potential costs. The SEC believes that, pursuant to comments on the proposed criteria, any subsequent modifications the Commissions make to proposed rule 3a69-2 would significantly curtail the potential for inadvertent inclusions or additional reporting or business conduct requirements.

The SEC requests comment as to the costs that determinations under and compliance with proposed rule 3a69-2 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a69-2 that have not been considered, and what the extent of those costs would be.

9. Proposed Rule 3a69-3.

a) Benefits.

Proposed rule 3a69-3 would provide that the term "security-based swap agreement" has the meaning set forth in section 3(a)(78) of the Exchange Act.[385] Proposed rule 3a69-3 also would provide that registered SDRs, swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants are not required to maintain additional books and records, or, in the case of registered SDRs, collect and maintain additional information regarding, SBSAs other than the books and records (and, in the case of registered SDRs, information) required to be kept (or

385 15 U.S.C. 78c(a)(78).

collected) and maintained regarding swaps pursuant to the CEA and the CFTC rules and regulations promulgated thereunder.

Because, as noted above, security-based swap agreements are subject the CFTC's regulatory and enforcement authority and the SEC's antifraud and certain other authority, the Commissions are concerned that, without further clarification, there may be uncertainty as to the scope of transactions that fall within the definition of the term "security-based swap agreement." Proposed rule 3a69-3(c) would define the term "security-based swap agreement" in the same manner as the term is defined in the Exchange Act. This rule, coupled with guidance regarding security-based swap agreements provided by the Commissions, further clarifies whether a swap is a security-based swap agreement and could eliminate the need to obtain an opinion of counsel regarding a particular security-based swap agreement.

Section 712(d)(2)(B) and (C) of the Dodd-Frank Act requires the Commissions to engage in joint rulemaking regarding books and records requirements for SBSAs. Providing that persons required to keep and maintain books and records regarding, or collect and maintain data regarding, swaps are not required to keep or maintain additional books and records regarding, or collect and maintain additional data regarding, SBSAs alleviates any additional books and records or information costs to such persons.

b) Costs.

The SEC believes that, because proposed rule 3a69-3 includes within the definition of SBSA no agreements, contracts, or transactions that would not be an SBSA in the absence of the proposed rule, proposed rule 3a69-3 would impose no costs other than those that are required with respect to swaps in the absence of proposed rule 3a69-3. In addition, the SEC believes that, because proposed rule 3a69-3 imposes no requirements with respect to SBSAs other than those that exist for swaps, proposed rule 3a69-3 would impose no costs other than those that are required with respect to swaps in the absence of proposed rule 3a69-3.

To the extent that the criteria under proposed rule 3a69-3 inadvertently lead to additional requirements with respect to SBSAs, these additional requirements could lead to costs for market participants entering into the SBSAs to which proposed rule 3a69-3 applies. The SEC has requested comment regarding whether the requirements under proposed rule 3a69-3 are sufficient. The SEC believes that, pursuant to comments on the proposed rule, any subsequent modifications the Commissions make to proposed rule 3a69-3 would significantly curtail the potential for inadvertent additional requirements.

The SEC requests comment as to the costs that compliance with proposed rule 3a69-3 would impose on market participants, as well as estimates and empirical data to support these costs. In addition, the SEC requests comment on any other costs associated with proposed rule 3a69-3 that have not been considered, and what the extent of those costs would be.

Request for Comment:

153. The SEC has considered the costs and benefits of the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the books and records requirements for SBSAs. The SEC is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the SEC requests comment on the potential costs, as well as any potential benefits, resulting from the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the books and records requirements for SBSAs for issuers, investors,

broker-dealers, security-based swap dealers, major security-based swap participants, persons associated with a security-based swap dealer or a major security-based swap participant, other security-based swap industry professionals, regulators, and other market participants. The SEC also seeks comment on the accuracy of any of the benefits identified and also welcomes comment on any of the costs identified here. In addition, the SEC encourages commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such costs or benefits, including estimates and views regarding these costs and benefits for particular types of market participants, as well as any other costs or benefits that may result from the adoption of the proposed rules, as well as the clarifications provided.

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

Section 3(f) of the Exchange Act[386] requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition, section 23(a)(2) of the Exchange Act[387] requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any rule that would impose a burden

386 15 U.S.C. 78c(f).

387 15 U.S.C. 78w(a)(2).

on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[388]

1. Proposed Rule 3a68-1a.

The SEC believes that proposed rule 3a68-1a would create an efficient process for a market participant to determine whether an index CDS is a swap or a security-based swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps and security-based swaps both are regulated pursuant to the Dodd-Frank Act by either the CFTC or the SEC, and an index CDS would be either a swap or a security-based swap, regardless of whether the SEC proposed rule 3a68-1a, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a68-1a would not impose any significant burdens on competition because an index CDS would be regulated as a swap or security-based swap regardless of whether the SEC proposed rule 3a68-1a. The proposed rule is a means of providing greater clarity for market participants on whether a specific index CDS is a swap or a security-based swap.

2. Proposed Rule 3a68-1b.

The SEC believes that proposed rule 3a68-1b would create an efficient process for a market participant to determine whether an index CDS is a swap or a security-based swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps and security-based swaps both are regulated pursuant to the Dodd-Frank Act by either the CFTC or the SEC, and an index CDS would be either a

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388 Id.

swap or a security-based swap, regardless of whether the SEC proposed rule 3a68-1b, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a68-1b would not impose any significant burdens on competition because an index CDS would be regulated as a swap or security-based swap regardless of whether the SEC proposed rule 3a68-1b. The proposed rule is a means of providing greater clarity for market participants on whether a specific index CDS is a swap or a security-based swap.

3. Proposed Rule 3a68-2.

The SEC believes that proposed rule 3a68-2 would create an efficient process for a market participant to request the Commissions to determine whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap) by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps, security-based swaps, and mixed swaps all are regulated pursuant to the Dodd-Frank Act by either the CFTC, the SEC, or both the CFTC and SEC, and because market participants still would need to determine whether an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or mixed swap regardless of whether the SEC proposed rule 3a68-2, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

In addition, the SEC believes the proposed rule will provide the opportunity for financial innovation by providing a flexible structure that will allow for the development of new products, which may promote capital formation.

Similarly, the SEC believes that proposed rule 3a68-2 would not impose any significant burdens on competition because, to the extent an agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap), that agreement, contract, or transaction (or class thereof) would be regulated as a swap, security-based swap, or mixed swap regardless of whether the SEC proposed rule 3a68-2. The proposed rule is a means of providing a process for market participants to request clarity regarding whether a specific agreement, contract, or transaction (or class thereof) is a swap, security-based swap, or mixed swap.

4. Proposed Rule 3a68-3.

The SEC believes that proposed rule 3a68-3 would create an efficient process for a market participant to determine whether a security index underlying a Title VII instrument is narrow-based or broad-based, and therefore whether the Title VII instrument is a swap or a security-based swap, by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because swaps and security-based swaps both are regulated pursuant to the Dodd-Frank Act by either the CFTC or the SEC, and a Title VII instrument on a security index would be either a swap or a security-based swap regardless of whether the SEC proposed rule 3a68-3, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a68-3 would not impose any significant burdens on competition because a Title VII instrument on a security index would be regulated as a swap or security-based swap regardless of whether the SEC proposed rule 3a68-3. The proposed rule is a means of providing greater clarity for market participants regarding whether a specific Title VII instrument on a security index is a swap or a security-based swap.

5. Proposed Rule 3a68-4.

The SEC believes that proposed rule 3a68-4 would create an efficient process for a market participant to request alternative regulatory treatment regarding a specified, or specified class of, mixed swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty and dual regulatory requirements. Because a mixed swap is regulated pursuant to the Dodd-Frank Act, and, absent proposed rule 3a68-4, persons that desire or intend to list, trade, or clear a mixed swap would be required to comply with all the statutory provisions in Title VII, including all the rules and regulations thereunder, that are applicable to both swaps and security-based swaps, the SEC believes that the proposed rule would not have an adverse effect on capital formation. Proposed rule 3a68-4 would permit such persons to request a joint order permitting themto comply with an alternative regulatory regime that would address the potential dual regulatory requirements applicable to transactions in mixed swaps under Title VII.

Similarly, the SEC believes that proposed rule 3a68-4 would not impose any significant burdens on competition because to the extent an agreement, contract, or transaction (or class thereof) is a mixed swap, transactions in that mixed swap would be subject to all of the statutory provisions of Title VII, including all the rules and regulations thereunder, that are applicable to both swaps and security-based swaps, if the Commissions were not to provide alternative regulatory treatment pursuant to proposed rule 3a68-4.

6. Proposed Rule 3a69-1.

The SEC believes that proposed rule 3a69-1 would create an efficient process for a market participant to determine whether an agreement, contract, or transaction is an insurance product and is not a swap by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because insurance products and insurance companies currently are regulated pursuant to state insurance law, and would continue to be so regardless of whether the SEC proposed rule 3a69-1, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a69-1 would not impose any significant burdens on competition because insurance products and insurance companies currently are regulated pursuant to state insurance law and would continue to be so regardless of whether the SEC proposed rule 3a69-1. The proposed rule is a means of providing greater clarity for market participants on whether a specific agreement, contract, or transaction is an insurance product and is not a swap.

7. Proposed Rule 3a69-2.

The SEC believes that proposed rule 3a69-2 would create an efficient process for a market participant to determine whether an agreement, contract, or transaction is a swap, a foreign exchange forward, or a foreign exchange swap or is subject to certain reporting and business conduct requirements, by setting forth clear methods and guidelines, thereby reducing potential uncertainty. Because agreements, contracts, and transactions that are swaps, foreign exchange forwards, or foreign exchange swaps under proposed rule 3a69-2 would be swaps, foreign exchange forwards, or foreign exchange swaps and, in the case of foreign exchange forwards and foreign exchange swaps, would be subject to reporting and business conduct requirements under the CEA, in the absence of proposed rule 3a69-2, the SEC believes that the proposed rule would not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a69-2 would not impose any significant burdens on competition because swaps, foreign exchange swaps, and foreign exchange forwards continue to be regulated as such regardless of whether the SEC proposed rule 3a69-2. The proposed rule is a means of providing greater clarity for market participants on whether a specific agreement, contract, or transaction is a swap, foreign exchange forward, or foreign exchange swap and whether certain reporting and business conduct requirements apply in the case of foreign exchange forwards and foreign exchange swaps.

8. Proposed Rule 3a69-3.

The SEC believes that proposed rule 3a69-3 would create an efficient process for registered SDRs, SDs, MSPs, security-based swap dealers, and major security-based swap participants to determine the books and records requirements for SBSAs by setting forth clear guidelines, thereby reducing potential uncertainty. Proposed rule 3a69-3(c) also would define the term "security-based swap agreement" in the same manner as the term is defined in the Exchange Act. Because SBSAs are swaps, they are subject to certain books and records requirements under the CEA (and CFTC rules and regulations promulgated thereunder) that are applicable to swaps and would continue to be so regardless of whether the SEC proposed rule 3a69-3. The SEC believes that the proposed rule would thus not have an adverse effect on capital formation.

Similarly, the SEC believes that proposed rule 3a69-3 would not impose any significant burdens on competition because SBSAs would be regulated as swaps regardless of whether the SEC proposed rule 3a69-3. The proposed rule is a means of providing greater clarity for market participants regarding SBSAs, including the books and records requirements for SBSAs.

Request for Comment:

154. The SEC requests comment on the possible effects of the proposed rules under the Exchange Act regarding efficiency, competition, and capital formation. The SEC requests that commenters provide views and supporting information regarding any such effects. The SEC notes that such effects are difficult to quantify. The SEC seeks comment on possible anti-competitive effects of the proposed rules under the Exchange Act not already identified. The SEC also requests comment regarding the competitive effects of pursuing alternative regulatory approaches that are consistent with section 712(a) and 712(d) of the Dodd-Frank Act. In addition, the SEC requests comment on how the other provisions of the Dodd-Frank Act for which SEC rulemaking is required will interact with and influence the competitive effects of the proposed rules and clarifications under the Exchange Act.

D. Consideration of Impact on the Economy.

For purposes of SBREFA the SEC must advise the OMB as to whether the proposed rules and interpretive guidance under the Exchange Act constitute "major" rules. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: 1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); 2) a major increase in costs or prices for consumers or individual industries; or 3) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

The SEC requests comment on the potential impact of the proposed rules and interpretive guidance under the Exchange Act on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

E. Initial Regulatory Flexibility Act Certification.

The RFA requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[389] of the Administrative Procedure Act,[390] as amended by the RFA, generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."[391] Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule or proposed rule amendment, that, if adopted, would not have a significant economic impact on a substantial number of small entities.[392]

For purposes of SEC rulemaking in connection with the RFA, a small entity includes: i) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of $5 million or less,[393] or ii) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal

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389 5 U.S.C. 603(a).

390 5 U.S.C. 551 et seq.

391 Although section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The SEC has adopted definitions for the term small entity for the purposes of SEC rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in rule 0-10, 17 CFR 240.0-10. See Statement of Management on Internal Accounting Control, 47 FR 5215, Feb. 4, 1982.

392 See 5 U.S.C. 605(b).

393 See 17 CFR 240.0-10(a).

year as of which its audited financial statements were prepared pursuant to rule 17a-5(d) under the Exchange Act,[394] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[395] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: i) for entities in credit intermediation and related activities, entities with $175 million or less in assets or, for non-depository credit intermediation and certain other activities, $7 million or less in annual receipts; ii) for entities in financial investments and related activities, entities with $7 million or less in annual receipts; iii) for insurance carriers and entities in related activities, entities with $7 million or less in annual receipts; and iv) for funds, trusts, and other financial vehicles, entities with $7 million or less in annual receipts.[396]

Based on the SEC's existing information about the swap markets, the SEC believes that the swap markets, while broad in scope, are largely dominated by entities such as those that would be covered by the "swap dealer," "security-based swap dealer," "major swap participant," and "major security-based swap participant" definitions.[397]

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394 See 17 CFR 240.17a-5(d).

395 See 17 CFR 240.0-10(c).

396 See 13 CFR 121.201.

397 See, e.g., CEA section 1a(49), 7 U.S.C. 1a(49) (defining "swap dealer"); section 3(a)(71)(A) of the Exchange Act, 15 U.S.C. 78c(a)(71)(A) (defining "security-based swap dealer"); CEA section 1a(33), 7 U.S.C. 1a(33) (defining "major swap participant");

The SEC believes that such entities exceed the thresholds defining "small entities" set out above. Moreover, although it is possible that other persons may engage in swap and security-based swap transactions, the SEC does not believe that any of these entities would be "small entities" as defined in rule 0-10 under the Exchange Act.[398] Feedback from industry participants about the swap markets indicates that only persons or entities with assets significantly in excess of $5 million (or with annual receipts significantly in excess of $7 million) participate in the swap markets.

To the extent that a small number of transactions did have a counterparty that was defined as a "small entity" under SEC rule 0-10, the SEC believes it is unlikely that the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the books and records requirements for SBSAs would have a significant economic impact on that entity. The proposed rules and clarifications simply would address whether certain products fall within the swap definition, address whether certain products are swaps, security-based swaps, SBSAs, or mixed swaps, provide a process for requesting interpretations of whether agreements, contracts, and transactions are swaps, security-based swaps, and mixed swaps, provide a process for requesting alternative regulatory treatment for mixed swaps, and establish books and records requirements for SBSAs, which are applicable to all entities.

For the foregoing reasons, the SEC certifies that the proposed rules and clarifications regarding the Product Definitions, the regulation of mixed swaps, and the

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section 3(a)(67)(A) of the Exchange Act, 15 U.S.C. 78c(a)(67)(A) (defining "major security-based swap participant"). Such entities also would include commercial entities that may use swaps to hedge or mitigate commercial risk.

398 See 17 CFR 240.0-10(a).

books and records requirements for SBSAs would not have a significant economic impact on a substantial number of small entities for purposes of the RFA. The SEC encourages written comments regarding this certification. The SEC requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

X. Statutory Basis and Rule Text.

List of Subjects:

17 CFR Part 1

Definitions, General swap provisions.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Commodity Futures Trading Commission

Pursuant to the Commodity Exchange Act, 7 U.S.C. 1 et seq., as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act"), and sections 712(a)(8), 712(d), 721(a), 721(b), 721(c), 722(d), and 725(g) of the Dodd-Frank Act, the CFTC is proposing to adopt rules 1.3(xxx) through 1.3(aaaa) and 1.6 through 1.9 under the Commodity Exchange Act.

Text of Proposed Rules

For the reasons stated in the preamble, the CFTC is proposing to amend Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6c, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 7, 7a, 7b, 8, 9, 10, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 21, 23, and 24.

2. Add §§ 1.3(xxx) through 1.3(aaaa) and §§ 1.6 through 1.9 to read as follows:

1.3(xxx)	(1) Definition of "swap"—in general
1.3(xxx)	(2) Definition of "swap"—particular products
1.3(xxx)	(3) Definition of "swap"—foreign exchange forwards and foreign exchange swaps
1.3(xxx)	(4) Definition of "swap"—insurance
1.3(xxx)	(5) Definition of "swap"—state
1.3(xxx)	(6) Definition of "swap"—anti-evasion
1.3(yyy)	Meaning of "narrow-based security index" as used in the definition of "security-based swap"
1.3(zzz)	Meaning of "issuers of securities in a narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps
1.3(aaaa)	Meaning of "narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps
1.6	Anti-evasion
1.7	Books and records requirements for security-based swap agreements
1.8	Interpretation of swaps, security-based swaps, and mixed swaps
1.9	Regulation of mixed swaps

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3. Amend Sec. 1.3 by adding paragraphs (xxx), (yyy), (zzz), and (aaaa) to read as follows:

§ 1.3 Definitions

* * * * *

(xxx) Swap. (1) In general. The term swap has the meaning set forth in section 1a(47) of the Commodity Exchange Act.

(2) Inclusion of particular products. (i) The term swap includes, without limiting the meaning set forth in section 1a(47) of the Commodity Exchange Act, the following agreements, contracts, and transactions:

(A) A cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(C) A foreign exchange forward;

(D) A foreign exchange swap;

(E) A forward rate agreement; and

(F) A non-deliverable forward involving foreign exchange.

(ii) The term swap does not include an agreement, contract, or transaction described in paragraph (xxx)(2)(i) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act.

(3) Foreign exchange forwards and foreign exchange swaps. Notwithstanding paragraph (xxx)(2) of this section:

(i) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act.

(ii) Notwithstanding paragraph (xxx)(3)(i) of this section:

(A) The reporting requirements set forth in section 4r of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(B) The business conduct standards set forth in section 4s of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(iii) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term foreign exchange forward has the meaning set forth in section 1a(24) of the Commodity Exchange Act.

(iv) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term foreign exchange swap has the meaning set forth in section 1a(25) of the Commodity Exchange Act.

(v) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act and this § 1.3(xxx), the following transactions are not foreign exchange forwards or foreign exchange swaps:

(A) A currency swap or a cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(C) A non-deliverable forward involving foreign exchange.

(4) Insurance. The term swap as used in section 1a(47) of the Commodity Exchange Act does not include an agreement, contract, or transaction that:

(i) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(A) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(B) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(C) Is not traded, separately from the insured interest, on an organized market or over-the-counter; and

(D) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(ii) Is provided:

(A) By a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such State or of the United States;

(B) By the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof; or

(C) In the case of reinsurance only, by a person located outside the United States to an insurance company that is eligible under paragraph (xxx)(4)(ii) of this section, provided that:

(1) Such person is not prohibited by any law of any State or of the United States from offering such agreement, contract, or transaction to such an insurance company;

(2) The product to be reinsured meets the requirements under paragraph (xxx)(4)(i) of this section to be insurance; and

(3) The total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

(5) State. For purposes of paragraph (xxx)(4) of this section, the term State means any state of the United States, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, or any other possession of the United States.

(6) Anti-Evasion:

(i) An agreement, contract, or transaction that is willfully structured to evade any provision of Subtitle A of the Wall Street Transparency and Accountability Act of 2010, including any amendments made to the Commodity Exchange Act thereby (Subtitle A), shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(ii) An interest rate swap or currency swap, including but not limited to a transaction identified in paragraph (xxx)(3)(v) of this section, that is willfully structured as a foreign exchange forward or foreign exchange swap to evade any provision of Subtitle A shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(iii) An agreement, contract, or transaction of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency (as defined in section 1a(2) of the Commodity Exchange Act), where the agreement, contract, or transaction is willfully structured as an identified banking product (as defined in section 402 of the Legal Certainty for Bank Products Act of 2000) to evade the provisions of the Commodity Exchange Act, shall be deemed a swap for purposes of the Commodity Exchange Act and the rules, regulations, and orders of the Commission promulgated thereunder.

(iv) The form, label, and written documentation of an agreement, contract, or transaction shall not be dispositive in determining whether the agreement, contract, or transaction has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section.

(v) An agreement, contract, or transaction that has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section shall be considered in determining whether a person is a swap dealer or major swap participant.

(vi) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.3(xxx)(6) or shall be considered for purposes of paragraph (xxx)(6)(v) of this section.

(yyy) Narrow-based security index as used in the definition of "security-based swap."

(1) In general. Except as otherwise provided in paragraphs (zzz) and (aaaa) of this section, for purposes of section 1a(42) of the Commodity Exchange Act, the term narrow-based security index has the meaning set forth in section 1a(35) of the Commodity Exchange Act, and the rules, regulations and orders of the Commission thereunder.

(2) Tolerance period for swaps traded on designated contract markets, swap execution facilities, and foreign boards of trade. Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade, a security index underlying such swaps shall not be considered a narrow-based security index if:

(i) (A) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade for at least 30 days as a swap on an index that was not a narrow-based security index; or

(B) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (yyy)(2)(i)(A) of this section; and

(ii) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(3) Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities. Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(i)(A) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(B) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index on a market described in paragraph (yyy)(3)(i)(A) of this section; and

(ii) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(4) Grace period.

(i) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade, an index that becomes a narrow-based security index under paragraph (yyy)(2) of this section solely because it was a narrow-based security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(ii) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (yyy)(3) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

(zzz) Meaning of "issuers of securities in a narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps.

(1) Notwithstanding paragraph 1.3(yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(III) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(III), as incorporated in section 1a(42) of the Commodity Exchange Act, the term issuers of securities in a narrow-based security index means issuers of securities identified in an index in which:

(i)(A) There are 9 or fewer non-affiliated issuers of securities that are reference entities in the index, provided that an issuer of securities shall not be deemed a reference entity for purposes of this section unless:

(1) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(2) The fact of such credit event or the calculation in accordance with paragraph (zzz)(1)(i)(A)(1) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (zzz)(2) of this section, for each reference entity included in the index, none of the following criteria is satisfied:

(1) The reference entity is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(2) The reference entity is eligible to rely on the exemption provided in rule 12g3-2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3-2(b));

(3) The reference entity has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(4) The reference entity (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(5) The reference entity is the issuer of an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(6) The reference entity is a government of a foreign country or a political subdivision of a foreign country;

(7) If the reference entity is an issuer of asset-backed securities as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), such asset-based securities were issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and have publicly available distribution reports; and

(8) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(i) The reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about the reference entity pursuant to rule 144A(d)(4) under the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(ii) Financial information about the reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(iii) In the case of a reference entity that is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15

U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the reference entity and such asset-backed securities; and

(ii)(A) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (zzz)(1)(i) of this section.

(2) Paragraph (zzz)(1)(i)(D) of this section will not apply with respect to a reference entity included in the index if:

(i) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(ii) The effective notional amounts allocated to reference entities that satisfy paragraph (zzz)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this § 1.3(zzz):

(i) A reference entity is affiliated with another entity if it controls, is controlled by, or is under common control with, that entity; provided that each reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(ii) Control means ownership of 20 percent or more of an entity's equity, or the ability to direct the voting of 20 percent or more of the entity's voting equity.

(iii) The term reference entity includes:

(A) An issuer of securities;

(B) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)); and

(C) A single reference entity or a group of affiliated entities; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) is a separate reference entity.

(aaaa) Meaning of "narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps.

(1) Notwithstanding paragraph 1.3(yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(I), as incorporated in section 1a(42) of the Commodity Exchange Act, the term narrow-based security index means an index in which:

(i)(A) The index is composed of 9 or fewer securities or securities that are issued by 9 or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(1) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(2) The fact of such credit event or the calculation in accordance with paragraph (aaaa)(1)(i)(A)(1) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (aaaa)(2) of this section, for each security included in the index, none of the following criteria is satisfied:

(1) The issuer of the security is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(2) The issuer of the security is eligible to rely on the exemption provided in rule 12g3-2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3-2(b));

(3) The issuer of the security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(4) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(5) The security is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(6) The issuer of the security is a government of a foreign country or a political subdivision of a foreign country;

(7) If the security is an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(8) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(i) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about such issuer pursuant to rule 144A(d)(4) of the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(ii) Financial information about the issuer of the security (other than an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(iii) In the case of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(ii)(A) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (aaaa)(1)(i) of this section.

(2) Paragraph (aaaa)(1)(i)(D) of this section will not apply with respect to securities of an issuer included in the index if:

(i) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(ii) The securities that satisfy paragraph (aaaa)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this § 1.3(aaaa):

(i) An issuer is affiliated with another issuer if it controls, is controlled by, or is under common control with, that issuer; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(ii) Control means ownership of 20 percent or more of an issuer's equity, or the ability to direct the voting of 20 percent or more of the issuer's voting equity.

(iii) The term issuer includes:

(A) An issuer of securities;

(B) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)); and

(C) A single issuer or a group of affiliated issuers; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) is a separate issuer.

* * * * *

4. Add Sec. 1.6 to read as follows:

§ 1.6 Anti-Evasion.

(a) It shall be unlawful to conduct activities outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade or attempt to evade any provision of the Commodity Exchange Act as enacted by

Subtitle A of the Wall Street Transparency and Accountability Act of 2010 or the rules, regulations, and orders of the Commission promulgated thereunder (Subtitle A).

(b) The form, label, and written documentation of an agreement, contract, or transaction, or an entity, shall not be dispositive in determining whether the agreement, contract, or transaction, or entity, has been entered into or structured to willfully evade as provided in paragraph (a) of this section.

(c) An activity conducted outside the United States to evade as provided in paragraph (a) of this section shall be subject to the provisions of Subtitle A.

(d) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.6.

5. Add Sec. 1.7 to read as follows:

§ 1.7 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be

collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(1)) and the rules and regulations thereunder; or

(4) a major security-based swap participant under section 15F(a)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(2)) and the rules and regulations thereunder.

(c) The term <u>security-based swap agreement</u> has the meaning set forth in section 1a(47)(A)(v) of the Commodity Exchange Act.

6. Add Sec. 1.8 to read as follows:

§ 1.8 Interpretation of swaps, security-based swaps, and mixed swaps.

(a) In general. Any person may submit a request to the Commission and the Securities and Exchange Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is:

(1) A swap, as that term is defined in section 1a(47) of the Commodity Exchange Act and the rules and regulations promulgated thereunder;

(2) A security-based swap, as that term is defined in section 1a(42) of the Commodity Exchange Act and the rules and regulations promulgated thereunder; or

(3) A mixed swap, as that term is defined in section 1a(47)(D) of the Commodity Exchange Act and the rules and regulations promulgated thereunder.

(b) Request process. In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Securities and Exchange Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both, (i.e., a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(c) Request withdrawal. A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commission and the Securities and Exchange Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Securities and Exchange Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (i.e., a mixed swap).

(d) Request by the Commission or the Securities and Exchange Commission. In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Securities and Exchange Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (i.e., a mixed swap), the Commission or the Securities and Exchange Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Securities and Exchange Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) Timeframe for joint interpretation.

(1) If the Commission and the Securities and Exchange Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint

interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Securities and Exchange Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Securities and Exchange Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint interpretation.

(5) If the Commission and the Securities and Exchange Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section, each of the Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) Joint notice of proposed rulemaking.

(1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the Securities and Exchange Commission may issue a joint notice of proposed rulemaking, in consultation with the Board of Governors of the Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint notice of proposed rulemaking described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

7. Add Sec. 1.9 to read as follows:

§ 1.9 Regulation of mixed swaps.

(a) In general. The term mixed swap has the meaning set forth in section 1a(47)(D) of the Commodity Exchange Act.

(b) Regulation of bilateral uncleared mixed swaps entered into by dually-registered dealers or major participants. A mixed swap: (i) that is neither executed on nor subject to the rules of a designated contract market, national securities exchange, swap execution facility, security-based swap execution facility, or foreign board of trade; (ii) that will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and (iii) where at least one party is registered with the Commission as a swap dealer or major swap participant and also with the Securities and Exchange Commission as a security-based swap dealer or major security-based swap participant, shall be subject to:

(1) The following provisions of the Commodity Exchange Act, and the rules and regulations promulgated thereunder:

(i) Examinations and information sharing: sections 4s(f) and 8 of the Commodity Exchange Act;

(ii) Enforcement: sections 2(a)(1)(B), 4(b), 4b, 4c, 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b), and 23 of the Commodity Exchange Act;

(iii) Reporting to a swap data repository: section 4r of the Commodity Exchange Act;

(iv) Real-time reporting: section 2(a)(13) of the Commodity Exchange Act;

(v) Capital: section 4s(e) of the Commodity Exchange Act; and

(vi) Position Limits: section 4a of the Commodity Exchange Act; and

(2) The provisions of the federal securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) Process for determining regulatory treatment for other mixed swaps.

(1) In general. Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Securities and Exchange Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the Commodity Exchange Act or the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), and the rules and regulations thereunder (collectively, specified parallel provisions), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. For purposes of this paragraph (c), parallel provisions means comparable provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934 that were added or amended by the Wall Street Transparency and Accountability Act of 2010 with respect to swaps and security-based swaps, and the rules and regulations thereunder.

(2) Request Process. A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Securities and Exchange Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(3) Request withdrawal. A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under paragraph (c)(4) of this section by the Commission and the Securities and Exchange Commission in response to the request.

(4) Issuance of orders. In response to a request under paragraph (c)(1) of this section, the Commission and the Securities and Exchange Commission, as necessary to carry out the purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. In determining the contents of such joint order, the Commission and the Securities and Exchange Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) Timeframe.

(i) If the Commission and the Securities and Exchange Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint order.

(iii) If the Commission and the Securities and Exchange Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

Securities and Exchange Commission

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly, sections 3 and 23 thereof, and sections 712(a)(8), 712(d), 721(a), 761(a) of the Dodd-Frank Act, the SEC is proposing to adopt rules 3a68-1a through 3a68-4 and 3a69-1 through 3a69-3 under the Exchange Act.

Text of Proposed Rules

For the reasons stated in the preamble, the SEC is proposing to amend Title 17, Chapter II of the Code of the Federal Regulations as follows:

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

1. 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, 78n-1, 78o, 78o-4, 78o-8, 78p, 78q, 78s, 78u-5, 78w, 78x, 78dd(b), 78dd(c), 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; 18 U.S.C. 1350; and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

2. Add §§ 240.3a68-1a through 240.3a68-4 and §§ 240.3a69-1 through 240.3a69-3 to read as follows:

* * * * *

§ 240.3a68-1a Meaning of "issuers of securities in a narrow-based security index" as used in section 3(a)(68)(A)(ii)(III) of the Act.

(a) Notwithstanding § 240.3a68-3(a) of this chapter, and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(III)), the term <u>issuers of securities in a narrow-based security index</u> as used in section 3(a)(68)(A)(ii)(III) of the Act means issuers of securities identified in an index in which:

(1)(i) There are 9 or fewer non-affiliated issuers of securities that are reference entities in the index, provided that an issuer of securities shall not be deemed a reference entity for purposes of this section unless:

(A) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each reference entity included in the index, none of the following criteria is satisfied:

(A) The reference entity is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The reference entity is eligible to rely on the exemption provided in § 240.12g3-2(b) of this chapter;

(C) The reference entity has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The reference entity (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(E) The reference entity is the issuer of an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The reference entity is a government of a foreign country or a political subdivision of a foreign country;

(G) If the reference entity is an issuer of asset-backed securities as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), such asset-based securities were issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and have publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(1) The reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about the reference entity pursuant to § 230.144A(d)(4)) of this chapter;

(2) Financial information about the reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(3) In the case of a reference entity that is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the reference entity and such asset-backed securities; and

(2)(i) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to a reference entity included in the index if:

(1) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(2) The effective notional amounts allocated to reference entities that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this § 3a68-1a:

(1) A reference entity is affiliated with another entity if it controls, is controlled by, or is under common control with, that entity; provided that each reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(2) <u>Control</u> means ownership of 20 percent or more of an entity's equity, or the ability to direct the voting of 20 percent or more of the entity's voting equity.

(3) The term <u>reference entity</u> includes:

(i) An issuer of securities;

(ii) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)); and

(iii) A single reference entity or a group of affiliated entities; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) is a separate reference entity.

§ 240.3a68-1b Meaning of "narrow-based security index" as used in section 3(a)(68)(A)(ii)(I) of the Act.

(a) Notwithstanding § 240.3a68-3(a) of this chapter, and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(I)), the term narrow-based security index as used in section 3(a)(68)(A)(ii)(I) of the Act means an index in which:

(1)(i) The index is composed of 9 or fewer securities or securities that are issued by 9 or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(A) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each security included in the index none of the following criteria is satisfied:

(A) The issuer of the security is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The issuer of the security is eligible to rely on the exemption provided in § 40.12g3-2(b) of this chapter;

(C) The issuer of the security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(E) The security is an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The issuer of the security is a government of a foreign country or a political subdivision of a foreign country;

(G) If the security is an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(1) The issuer of the security (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about such issuer pursuant to § 230.144A(d)(4)) of this chapter;

(2) Financial information about the issuer of the security (other than an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(3) In the case of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(2)(i) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be a narrow-based security index under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to securities of an issuer included in the index if:

(1) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(2) The securities that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this § 240.3a68-1b:

(1) An issuer is affiliated with another issuer if it controls, is controlled by, or is under common control with, that issuer; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuing entity of an asset-backed security.

(2) Control means ownership of 20 percent or more of an issuer's equity, or the ability to direct the voting of 20 percent or more of the issuer's voting equity.

(3) The term issuer includes:

(i) An issuer of securities;

(ii) An issuing entity of an asset-based security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)); and

(iii) A single issuer or a group of affiliated issuers; provided that each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) is a separate issuer.

§ 240.3a68-2 Interpretation of swaps, security-based swaps, and mixed swaps.

(a) In general. Any person may submit a request to the Commission and the Commodity Futures Trading Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is a swap, as that term is defined in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) and the rules and regulations promulgated thereunder, a security-based swap, as that term is defined in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and the rules and regulations promulgated thereunder, or a mixed swap, as that term is defined in section 3(a)(68)(D) of the Act and the rules and regulations promulgated thereunder.

(b) Request process. In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Commodity Futures Trading Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(c) Request withdrawal. A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commission and the Commodity Futures Trading Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Commodity Futures Trading Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (i.e., a mixed swap).

(d) Request by the Commission or the Commodity Futures Trading Commission. In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Commodity Futures Trading Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (i.e., a mixed swap), the Commission or the Commodity Futures Trading Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Commodity Futures Trading Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) Timeframe for joint interpretation.

(1) If the Commission and the Commodity Futures Trading Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Commodity Futures Trading Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Commodity Futures Trading Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint interpretation.

(5) If the Commission and the Commodity Futures Trading Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section, each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) Joint notice of proposed rulemaking.

(1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the Commodity Futures Trading Commission may issue a joint notice of proposed rulemaking, in consultation with the Board of Governors of the

Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint notice of proposed rulemaking described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

§ 240.3a68-3 Meaning of "narrow-based security index" as used in the definition of "security-based swap."

(a) In general. Except as otherwise provided in § 240.3a68-1a and § 240.3a68-1b of this chapter, for purposes of section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)), the term narrow-based security index has the meaning set forth in section 3(a)(55) of the Act (15 U.S.C. 78c(a)(55)), and the rules, regulations, and orders of the Commission thereunder.

(b) Tolerance period for swaps traded on designated contract markets, swap execution facilities and foreign boards of trade. Notwithstanding paragraph (a) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.), a security index underlying such swaps shall not be considered a narrow-based security index if:

(1)(i) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.) for at least 30 days as a swap on an index that was not a narrow-based security index; or

(ii) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (b)(1)(i) of this section; and

(2) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(c) Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities. Notwithstanding paragraph (a) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(1)(i) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(ii) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index on a market described in paragraph (c)(1)(i) of this section; and

(2) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(d) Grace period.

(1) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.), an index that becomes a narrow-based security index under paragraph (b) of this section solely because it was a narrow-based

security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(2) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (c) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

§ 240.3a68-4 Regulation of mixed swaps.

(a) In general. The term mixed swap has the meaning set forth in section 3(a)(68)(D) of the Act (15 U.S.C. 78c(a)(68)(D)).

(b) Regulation of mixed swaps entered into by dually-registered dealers or major participants. A mixed swap:

(1) That is neither executed on nor subject to the rules of a designated contract market, national securities exchange, swap execution facility, security-based swap execution facility, or foreign board of trade;

(2) That will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and

(3) Where at least one party is registered with the Commission as a security-based swap dealer or major security-based swap participant and also with the Commodity Futures Trading Commission as a swap dealer or major swap participant, shall be subject to:

(i) The following provisions of the Commodity Exchange Act (7 U.S.C. 1 et seq.), and the rules and regulations promulgated thereunder, set forth in the rules and regulations of the Commodity Futures Trading Commission:

(A) Examinations and information sharing: 7 U.S.C. 6s(f) and 12;

(B) Enforcement: 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 9, 13b, 13a-1, 13a-2, 13, 13c(a), 13c(b), 15 and 26;

(C) Reporting to a swap data repository: 7 U.S.C. 6r;

(D) Real-time reporting: 7 U.S.C. 2(a)(13);

(E) Capital: 7 U.S.C. 6s(e); and

(F) Position Limits: 7 U.S.C. 6a; and

(ii) The provisions of the federal securities laws, as defined in section 3(a)(47) of the Act (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) Process for determining regulatory treatment for mixed swaps.

(1) In general. Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Commodity Futures Trading Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the Act (15 U.S.C. 78a et seq.) or the Commodity Exchange Act (7 U.S.C. 1 et seq.), and the rules and regulations thereunder (collectively, specified parallel provisions), instead of being required to comply with parallel provisions of both the Act and the Commodity Exchange Act. For purposes of this paragraph (c), parallel provisions means comparable provisions of the Act and the Commodity Exchange Act

that were added or amended by the Wall Street Transparency and Accountability Act of 2010 with respect to security-based swaps and swaps, and the rules and regulations thereunder.

(2) Request process. A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Commodity Futures Trading Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(3) Request withdrawal. A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under

paragraph (c)(4) of this section by the Commission and the Commodity Futures Trading Commission in response to the request.

(4) Issuance of orders. In response to a request under paragraph (c)(1) of this section, the Commission and the Commodity Futures Trading Commission, as necessary to carry out the purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Act (15 U.S.C. 78a et seq.) and the Commodity Exchange Act (7 U.S.C. 1 et seq.). In determining the contents of such joint order, the Commission and the Commodity Futures Trading Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) Timeframe.

(i) If the Commission and the Commodity Futures Trading Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint order.

(iii) If the Commission and the Commodity Futures Trading Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

§ 240.3a69-1 Definition of "swap" as used in section 3(a)(69) of the Act—Insurance

The term swap as used in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) does not include an agreement, contract, or transaction that:

(a) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(1) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(2) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(3) Is not traded, separately from the insured interest, on an organized market or over-the-counter; and

(4) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(b) Is provided:

(1) By a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any State, as defined in section 3(a)(16) of the Act (15 U.S.C. 78c(a)(16)), or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such State or of the United States;

(2) By the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof; or

(3) In the case of reinsurance only, by a person located outside the United States to an insurance company that is eligible under paragraph (b) of this section, provided that:

(i) Such person is not prohibited by any law of any State or of the United States from offering such agreement, contract, or transaction to such an insurance company;

(ii) The product to be reinsured meets the requirements under paragraph (a) of this section to be insurance; and

(iii) The total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

§ 240.3a69-2 Definition of "swap" as used in section 3(a)(69) of the Act—Additional Products.

(a) In general. The term swap has the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)).

(b) Inclusion of particular products. (1) The term swap includes, without limiting the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69), the following agreements, contracts, and transactions:

(i) A cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(iii) A foreign exchange forward;

(iv) A foreign exchange swap;

(v) A forward rate agreement; and

(vi) A non-deliverable forward involving foreign exchange.

(2) The term swap does not include an agreement, contract, or transaction described in paragraph (b)(1) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act (7 U.S.C. 1a(47)(B)).

(c) Foreign exchange forwards and foreign exchange swaps. Notwithstanding paragraph (b)(2) of this section:

(1) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)(i)).

(2) Notwithstanding paragraph (c)(1) of this section:

(i) The reporting requirements set forth in section 4r of the Commodity Exchange Act (7 U.S.C. 6r) and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(ii) The business conduct standards set forth in section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(3) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this § 240.3a69-2, the term foreign exchange forward has the meaning set forth in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)).

(4) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this § 240.3a69-2, the term foreign exchange swap has the meaning set forth in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25)).

(5) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(24) and (25)) and this § 240.3a69-2, the following transactions are not foreign exchange forwards or foreign exchange swaps:

(i) A currency swap or a cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(iii) A non-deliverable forward involving foreign exchange.

§ 240.3a69-3 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act (7 U.S.C. 6s(a)(1)) and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act (7 U.S.C. 6s(a)(2)) and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Act (15 U.S.C. 78o-10(a)(1)) and the rules and regulations thereunder; or

(4) A major security-based swap participant under section 15F(a)(2) of the Act (15 U.S.C. 78o-10(a)(2)) and the rules and regulations thereunder.

(c) The term security-based swap agreement has the meaning set forth in section 3(a)(78) of the Act (15 U.S.C. 78c(a)(78)).

By the Commodity Futures Trading Commission.

David A. Stawick
Secretary

Date: April 29, 2011

By the Securities and Exchange Commission.

Cathy H. Ahn
Deputy Secretary

Date: April 29, 2011

Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act—CFTC Voting Summary and Statements of CFTC Commissioners

NOTE: The following will not appear in the Code of Federal Regulations

CFTC Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Chilton and O'Malia voted in the affirmative; Commissioner Sommers voted in the negative.

Statement of CFTC Chairman Gary Gensler

I support the proposed rulemaking to implement the Dodd-Frank Act's requirement to further define derivatives products that come under Title VII of the Act.

The CFTC worked closely with the SEC, in consultation with the Federal Reserve, on this proposed rule to further define swaps, security-based swaps, mixed swaps and security-based swap agreements. The statutory definition of swap is very detailed. This rule is consistent with that detailed definition and Congressional intent. For example, interest rate swaps, currency swaps, commodity swaps, including energy, metals and agricultural swaps, and broad-based index swaps, such as index credit default swaps, are all swaps. Consistent with Congress's definition of swaps, the rule also defines options as swaps.

In preparing the proposed rule, staff worked to address the more than 80 comments that were submitted by the public in response to the joint advance notice of proposed rulemaking on product definitions. Many of the commenters asked that the Commissions specifically provide guidance on what is not a swap or security-based swap.

For example, under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there has been a series of orders, interpretations and cases that market participants have come to rely upon regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of swaps "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." The proposed rule interprets that exclusion in a manner that is consistent with the Commission's previous history of the forward exclusion from futures regulation.

Further, consistent with the Dodd-Frank Act, the proposed rule clarifies that state or federally regulated insurance products that are provided by regulated insurance companies will not be regulated under Title VII of the Act. Similarly, the proposal clarifies that certain consumer and commercial arrangements that historically have not been considered swaps, such as consumer mortgage rate locks, contracts to lock in the price of home heating oil and contracts relating to inventory or equipment, also will not be regulated under Title VII of the Act.

Statement of CFTC Commissioner Jill Sommers

I respectfully dissent from the action taken today by the Commission to issue proposed regulations relating to "Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act."

I disagree with the approach taken by the Commission with regard to the proposed "Anti-Evasion" provisions. I agree that Dodd-Frank Section 721(c) directs the Commission to further define certain terms to include transactions or entities that have been structured to evade Dodd-Frank. I do not agree that Congress directed the Commission to promulgate broad "Anti-Evasion" provisions, and I point out that the Securities and Exchange Commission today has declined to promulgate such provisions in this joint rulemaking.

By promulgating a broad regulation today that essentially says that any transaction that does not fall within the definition of "swap" because it has been structured to evade Dodd-Frank nonetheless is a swap, the Commission is over-reading its Congressional mandate. The statutory definition of "swap" includes a laundry-list of transactions that Congress intended to include within the definition. If Congress intended the definition of "swap" also to include a broad statement that any transaction structured to evade Dodd-Frank is a "swap," Congress would have incorporated such a provision within the statutory definition. By directing the Commission to "further define" the term "swap" by rule, Congress is directing the Commission not to make the broad statement it declined to make, but to think through whether the definition of "swap" needs to be modified by rule to include specific transactions within the definition.

In addition to my concern about the "Anti-Evasion" provisions included within this proposal, I am concerned about an important issue that is not raised within this proposal. Multinational organizations whose statutory mission is to combat poverty and foster economic development have raised concerns about the application of Dodd-Frank to their activities. This proposal omits any discussion of their issues. In my view the following language should be included within the proposal, and I urge the public to comment upon the issues raised:

Transactions Involving Certain Foreign or Multinational Entities

The swap definition expressly excludes "any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States."[399] Some commenters have suggested that the Commissions should exercise their authority to further define the terms "swap" and "security-based swap" to similarly exclude transactions in which a counterparty is an international public organization, a foreign central bank, a foreign sovereign, or a multi-or supra-national organization.[400] Commenters have advanced international comity, national treatment, limited regulatory

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399 7 U.S.C. 1a(47)(B)(ix).

400 See, e.g., letter from Gunter Pleines, Head of Banking Department, and Diego Devos, General Counsel, Bank for International Settlements ("BIS Letter"); Cleary Letter. The Commissions note that various other terms may be used to refer to organizations that generally: i) limit their membership to sovereign nations; ii) are established by treaty; iii) have a separate legal identity from their members; and iv) "are usually specialized and of international or regional scope" and "formed between three or more nations to work on issues that relate to all of the countries in the organization. See, e.g., http://portal.unesco.org/en/ev.php-URL_ID=32408&URL_DO=DO_TOPIC&URL_SECCTION=201.html; http://www.geni.org/globalenergy/library/organizations/index.shtml. For convenience, the Commissions use the term "supranational organization" herein to refer to organizations having such characteristics.

resources, limits on the Commissions' respective extraterritorial jurisdiction, and international harmonization as rationales for such an approach.[401]

Request for Comment

- The Commissions request comment generally on the appropriate application of the Dodd-Frank Act to international public organizations, foreign central banks, foreign sovereigns (or foreign sovereign wealth funds), supranational organizations, and any other foreign or multinational entity that may be analogous to the entities excluded from the swap definition in CEA Section 1a(47)(B)(ix).

- Should the Commissions further define the terms "swap" and "security-based swap" to exclude transactions in which a counterparty is an international public organization, foreign central bank, foreign sovereign (or foreign sovereign wealth fund), supranational organization, or any other foreign or multinational entity that may be analogous to an entity excluded from the swap definition in CEA Section 1a(47)(B)(ix)? Why or why not? If so, how should the Commissions delineate the scope of entities whose transactions

401 See, e.g., BIS Letter (citing Article 1, paragraph 4, of the proposed EU Regulation on Central Clearing of OTC Derivatives, available at http://register.consilium.europa.eu/pdf/en/11/st05/st05059.en11.pdf, which excludes from its coverage the BIS, multilateral development banks, European central banks and similarly situated "other national bodies performing similar functions and other public bodies charged with or intervening in the management of the public debt").

would be excluded? Please describe in detail the nature of the entity whose transactions would be excluded and explain the reasons for such an exclusion. Would such an exclusion inappropriately cause transactions that should be regulated as swaps or security-based swaps to fall outside of the regulatory regime established by the Dodd-Frank Act? Why or why not?

- If the Commissions further define the terms "swap" and "security-based swap" to exclude any such entity, should the exclusion be subject to any conditions, or should the exclusion be limited to particular requirements of Title VII? Why or why not? If so, what conditions would be appropriate, and/or what requirements of Title VII should the exclusion apply to, and why?

- If the Commissions further define the terms "swap" and "security-based swap" to exclude any such entity, to what extent should counterparties to such transactions be subject to the requirements of Title VII? What would be the appropriate regulatory treatment of such counterparties in these circumstances?